Joint WB-IsDB G20 Islamic Finance Policy Paper

LEVERAGING ISLAMIC FINANCE FOR SMEs

World Bank Finance and Markets Global Practice

Islamic Development Bank

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Leveraging Islamic Finance for SMEs

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ACRONYMS AND ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
AIM	Alternative Investment Market
CGAP	Consultative Group to Assist the Poor
EMDCs	Emerging Markets and Developing Countries
EU	European Union
GCC	Gulf Cooperation Council
GIZ	Gesellschaft für Internationale Zusammenarbeit
GPFI	Global Partnership for Financial Inclusion
IDB	Islamic Development Bank
IDOs	International Development Organizations
IFC	International Finance Corporation
IFSB	Islamic Financial Services Board
IIWG	Investment and Infrastructure Working Group
IPO	Initial Public Offering
ISRA	International *Shariah* Research Academy for Islamic Finance
MENA	Middle East and North Africa
MSMEs	Micro, Small and Medium Enterprises
NGOs	Non-Governmental Organizations
OECD	Organization for Economic Cooperation and Development
OIC	Organization of Islamic Cooperation
PE	Private Equity
SFD	Social Fund for Development
SIDBI	Small Industries Development Bank of India
SMEs	Small and Medium Enterprises
SRI	Social Responsible Investment
VC	Venture Capital
YESP	Youth Employment Support Program

GLOSSARY OF TERMS

Ijara	A contract through which one party "lessor" leases an asset to be used by a client "lessee" for a period of time and in return for an agreed rental fee. Another form of *Ijara* – *Ijara wa Iqtina* – is a lease to own, with an additional unilateral undertaking by only one of the parties to buy or sell the asset at the end of the lease period.
Diminishing Musharaka	A *Musharaka* agreement where the entrepreneur promises to buy the investment shares of the other partner(s) over time until the entrepreneur owns 100% of the venture
Kafala	An undertaking given by the guarantor (*Kafeel*) to a creditor that the debtor will pay his financial obligations, thereby joining the latter's liability to his. This allows the debtor to have more opportunities in access to finance by having a backing from a credible institution.
Mudaraba	A partnership between a capital provider (*Rab-ul-Mal*) and an entrepreneur who is acting as fund manager (*Mudarib*) to invest the capital in a project. Profits may be distributed at any pre-agreed ratio, while losses are borne by the capital provider.
Murabaha	A contract between a financier and a client through which the financier purchases assets required by the client and then sells them to the client at a cost that includes a disclosed profit margin to be paid back, usually in installments.
Musharaka	A partnership agreement established by two or more parties where all parties provide capital into a joint venture to share its profits and losses. Profits are distributed among partners based on their shareholding in the capital but they can agree on whatever ratios for profit distribution while losses have to be borne by the partners proportional to their capital contribution.
***Qard* Hassan**	The term for "benevolent loan", it is an interest-free loan.
Riba	"Interest payment" or an excess payment added to the principle amount of debt collected by a creditor in return of lending a loan to a debtor.

Salam	A forward sale contract in which an advance payment is made for commodities (mainly agricultural crops) to be delivered at a future date. A *Salam* can thus be utilized to provide working capital to SMEs.
Securitization	The process of pooling a number of contractual debts such as corporate debts, mortgages, auto loans or credit card debt obligations (or other non-debt assets which generate receivables) and selling their related cash flows to third party investors as securities, which may be described as bonds, pass-through securities, or collateralized debt obligations (CDOs).
Shariah	Islamic law based on the text of the holy *Quran*, actions of the prophet Muhammed (*Sunnah*), this law describes in detail what is permissible and what is not permissible for all behavioral and contractual relationships.
Sukuk	The Islamic equivalent of "bonds", however; *Sukuk* can only be issued for asset-based debt obligations and as opposed to bonds they are not only a debt ownership but it entitle the holder to ownership in the underlying assets and its cash flows.
Takaful	The term for Islamic insurance, its main distinction from conventional insurance is the cooperative system of collecting the "contributions" and distribution of profits/losses among the pool of insurers, which eliminates the uncertainty of the contractual relationship with the insurance company.
Wakala	A contract where a person authorizes another to do a certain well-defined legal action on his behalf. It is a contract of agency where the agent (*Wakeel*) is someone who establishes contractual and commercial relations between a principal and a third party, usually against a fixed fee.

Executive Summary

Small and Medium Enterprises and high growth startups are the backbone of developed as well as Emerging Markets and Developing Countries (EMDCs) in terms of employment generation, opportunity, and sustainability and as well as economic growth. Globally, SME contribution to total employment is estimated to be 43.5% and considered to be responsible for 57.8% of total new jobs created. The relevance of these figures has to be set in context with the necessity of creating about 600 million jobs around the world by 2030 to keep up with the growth of the labour force. In terms of economic growth, formal SMEs contribute up to 33% of GDP in developing countries and up to 51% in high income countries.

The major challenge faced by SMEs however is access to finance. According to the IFC (2012), the total MSME financing gap in developing countries is estimated to be US$ 2.4 trillion out of which a gap of about US$ 1.3 trillion exists in G20 countries covered within the IFC Financing Gap database. The financing gap in EMDCs becomes even more severe since financial institutions such as banks widely consider SMEs as being too risky due to factors such as lack of collaterals and non-sufficient credit history. About 55-68% of SMEs in developing countries are either financially underserved or not served at all resulting in lost opportunties to develop their SMEs.

Islamic banking and finance has shown remarkable global success in terms of growth, expansion, and institutional and product diversification. Islamic banking and finance industry grew by a compound annual growth rate of about 17%, reaching more than US$1.87 trillion in total assets by the first half of 2014. Additionally, according to the IFSB, the Islamic banking sector grew by 16% in 2013 compared to the overall global banking growth (based on the assets of the top 1000 global banks, which grew by only 4.9% in 2012 and 0.6% in 2013).

The asset-backed finance and risk-sharing nature of Islamic financial products aims to contribute to social and economic development through promoting entrepreneurship. Asset-based financing ensures that the transaction is financing real economic activity based on close linkage to the financed assets ensuring less *"financilization"* in the economy. Equity-based financing on the other hand promotes profit-and-loss sharing between financiers and entrepreneurs resulting in increased alignment of interests, increased risk sharing and fostering entrepreneurship especially of seed and early-stage startups, which rely purely on equity financing for their ventures.

Islamic SME banking challenge can be met by adequate policy response. A critical assessment of the unmet demand of SMEs by Islamic banks with a detailed analysis of the reasoning behind this through identifiying the Islamic SME banking challenges and defining a set of recommendations to overcome each of these challenges. These recommendations are listed in *Table E1* below.

Table E1: Key Recommendations to meet Islamic SME Banking Challenges

CHALLENGE	RECOMMENDATIONS
INCREASE PRODUCT OFFERINGS	- Practical education especially in Risk Management for equity-based financing - Risk mitigation techniques and systems for equity-based financing - Study tours and knowledge exchange especially with Indonesia - Supporting the establishment of Non-banking financial services providing Ijara (Leasing companies), Mudaraba and Musharaka (Venture Capital companies)
SUPPORT STANDARDIZATION	- Adaptation by Central Banks and Security Commissions and Authorities responsible for Non-banking Financial Services - Criteria for Shariah board formations and Shariah scholars - Centralized Shariah Boards and issuance of guidelines (Example: Malaysian Security Commission)
REDUCE TRANSACTION COSTS AND TAXES	- Increased standardization and information sharing will reduce cost - Knowledge hub for standard Islamic financial transactions - Laws for tax treatment of Islamic financial instruments
IMPROVE USE OF MOVABLE COLLATERALS	- Legal framework for secured transactions including movable assets - Reliable collateral registries - Claim enforcement mechanisms - Capacity building and training on processes and systems
INCREASED INFORMATION SHARING	- Tax incentives for angel and crowd investors - Digital payments and company structuring - Reduction of digital transaction costs - Crowdfunding regulation - Cross-border capital transfer - Technical assistance for crowdfunding platforms and entrepreneurship education in universities
IMPROVE CAPABILITIES OF HUMAN RESOURCES	- Creating the SME Islamic Finance Forum Platform including standardized documentation, Shariah standards and operation manuals in multiple languages and based on different jurisdictions to support Islamic MSME financing - Knowledge platform with interaction among practitioners - Case studies database on platform including best practices
IMPROVE ISLAMIC FINANCE LITERACY	- Multi-lingual Islamic Finance education platform - Promotional material - Training and workshops for staff members facing clients
IMPROVE BRANDING	- Inclusive approach branding Islamic finance as Ethical finance - Increase of equity-based financing with clients and showcasing success stories - Creation of Islamic Finance or Ethical Quality Indexes

Securities rights in movable assets are critical to SMEs because these enterprises frequently have only movable assets to provide as security for financing. According to De La Campa (2010), 78 percent of assets of businesses in developing countries are movable assets in the form of machinery, equipment and vehicles. Understanding the implication of Islamic Law (Shariah) on Model Law on securities[1] is critical to promote SME finance through Islamic products. A report entitled "Legal Regime for Security Rights in Movable Collateral: An Analysis of the UNCITRAL Model Law from a Shari'ah Perspective" is in progress by the World Bank, IFC, and IsDB. Annex A lists short summary of key differences and potential resolutions.

Mobilization of financing from non-banking channels such as private equity, venture capital, and capital markets offers an opportunity to overcome the shortcomings of banks' SME financing with innovative and desired asset-based and equity-based financial products. Profit-and-loss sharing through equity-based financial instruments is highly encouraged by Islamic finance and there exists a wide array of conventional non-banking financial instruments that are compatible with Islamic finance principles or could be made compatible with minimal effort.

The recommendations for the policy makers, financial institutions and IDOs to improve access to asset-based and equity-based financing by non-banking financial service providers are summarized in *Table E2*.

Table E2: Non-Bank Financing Channels for SMEs

SERVICE	RECOMMENDATIONS
CREDIT GUARANTEES	- International knowledge-transfer to EMDCs - Technical assistance from IDOs to Central banks and Credit Guarantee Companies - Increasing funding to serve larger base of SMEs - Law enforceability - Human resources development
LEASING	- Improved leasing laws - Increasing funding sources - Technical assistance especially in Islamic leasing - Human resources development
CAPITAL MARKETS	- Sukuk laws in G20 and EMDCs - Further standardization of Islamic law practices in finance - Incentives for SME Stock Exchanges

[1] Within the Working Group VI (Security Interests) of UNCITRAL, a comprehensive legal regime including the Model Law for secured transactions over movables has been developed.

VENTURE CAPITAL	- Laws for SPVs - Technical assistance for Islamic VC structures - Reducing capital gain taxation - Enforceability of shareholder agreements - Increasing funding sources - Increase in government VC funds and programs - IDO co-investment funds - Domestic success stories - Increasing number of incubators and accelerators - International mentorship programs
ANGEL INVESTMENTS / CROWDFUNDING	- Tax incentives for angel and crowd investors - Digital payments and company structuring - Reduction of digital transaction costs - Crowdfunding regulation - Cross-border capital transfer - Technical assistance for crowdfunding platforms and entrepreneurship education in universities

Finally, Islamic finance can play a significant role in meeting financing-gap for SMEs and therefore, policy-makers and stakeholder should give serious considerations of promoting asset-backed and equity financial instruments to leverage Islamic finance. By developing an enabling environment for asset-based and equity-based finance, markets could attract excess liquidity available in Islamic financial markets especially in the Middle East seeking attractive investment opportunities.

Setting Islamic finance in the context of the broader global agenda to support SME Finance. The priority reform measures supported by G20 Investment and Infrastructure Working Group (IIWG) and Global Partnership on Financial Inclusion (GPFI) could provide roadmap for effective implementation of Islamic financial products. Table E3 highlights key reform areas from an Islamic finance perspective. The consideration of the Islamic finance perspective into the agenda would enrich the development of reforms and creating of knowledge utilizing asset-based and equity-based financing alternatives capable to improve the SME financing landscape.

Table E3: Key Reform Areas on SMEs and Relevance to Islamic Finance[2]

PRIORITY REFORM MEASURES & ACTION PLAN AGENDA ITEMS	RELEVANCE TO ISLAMIC FINANCE
Financial Markets Infrastructure Reforms	
1. Improvements of the credit reporting framework for SMEs	Equally applicable to Islamic finance as it will improve the business practices of SMEs and help them reach best business practices
2. Reforms that allow banks and non-banks to lend to SMEs against movable collateral	Critical issue as there are differences in the treatment of movable collateral under Model Law on security interests and Islamic Law (*Shariah*). See Annex A for further details of the differences.
3. Insolvency reforms	Differences in insolvency laws need to be resolved especially for cross-border transactions.
Knowledge Agenda	
1. Drivers and constraints for innovative SME finance policies and instruments	Asset-backed and equity-financing based crowdfunding models could be utilized in a manner compliant with Islamic Law.
2. Addressing SME data gaps	Enhanced estimates of demand and supply gaps in countries with voluntary exclusion on the basis of lack of availability of financial products.
3. SME long term financing- asset backed financing	Very critical. Further knowledge development in the areas of credit guarantees, securitization, *Sukuk*, private equity and venture capital based SME financing.

[2] *Source:* http://www.gpfi.org/.

CHAPTER 1

ISLAMIC Finance AND SMEs

1.1 SMEs and Access to Finance

Small and Medium Enterprises and high growth startups are the backbone of developed as well as Emerging Markets and Developing Countries (EMDCs) in terms of employment and intergenerational sustainability as well as economic growth.

Globally, SME contribution to total employment is estimated to be 43.5% and considered to account for 57.8% of total new jobs created.[3] The relevance of these figures has to be considered in context with the necessity of creating about 600 million jobs around the world by 2030 to keep up with the growth of the labour force (World Bank, 2014a). In terms of economic growth, formal SMEs contribute up to 33% of GDP in developing countries (IFC, 2010) and up to 51% in high income countries (SME Corp, 2015).

Various studies have been conducted across different countries and regions confirming that the SME sector is the key economic driver of the national economies despite of various existing definitions of SMEs in terms of number of employees or total turnover. According to the OECD (2014) for instance, the value added created by SMEs with less than 250 employees has been 56.3% in Germany, 71.0% in Italy and 54.6% in Turkey.

Other important factors regarding SMEs in general and startups specifically are their increased engagement of women and youth as well as their ability to adapt faster to change as compared to large corporations, resulting in the creation and enhancement of innovative solutions.

While SMEs have this level of socioeconomic significance, their relevance and impact are not proportionally met with support mechanisms and channels that would enable the growth of existing as well as the establishment of new SMEs to flourish and to increase their economic and social magnitude. SMEs across the world – and especially in developing countries - are facing challenges which are, to a large extent, similar in nature and include access to finance, high transaction costs, the availability of skilled human resources, legal and regulatory environments, access to technology and inadequate access to markets.

[3] Ayyagari, Demirguc-Kunt and Maksimovic (2011)

Table 1.1: MSME Credit Gap in Selected G20 Countries[4]

Country	Number of Enterprises in thousands	Total Credit Gap, US$, billions	Access to Finance as Major/Severe Barrier
Argentina	2,133	67	34%
Brazil	16,030	237	42%
China	103,548	338	18%
India	49,634	140	23%
Indonesia	41,116	28	15%
Korea	4,644	114	17%
Russia	3,605	50	44%
Saudi Arabia	1,843	237	42%
South Africa	2,213	13	15%
Turkey	4,120	73	20%
Total	**228,886**	**1,297**	

The major challenge faced by SMEs, however, is access to finance. According to the IFC Finance Gap Database, the total MSME financing gap in developing countries is estimated to be US$ 2.4 trillion out of which a gap of about US$ 1.3 trillion exists in G20 countries covered within the IFC Finance Gap Database (*see Table 1.1*).

The financing gap in developing countries becomes even more severe since financial institutions such as banks widely consider SMEs as being too risky due to factors such as lack of collaterals and non-sufficient credit history. As can be seen in *Figure 1.1*, about 55-68% of SMEs in developing countries are either financially underserved or not served at all resulting in lost opportunties to realize their full potential.

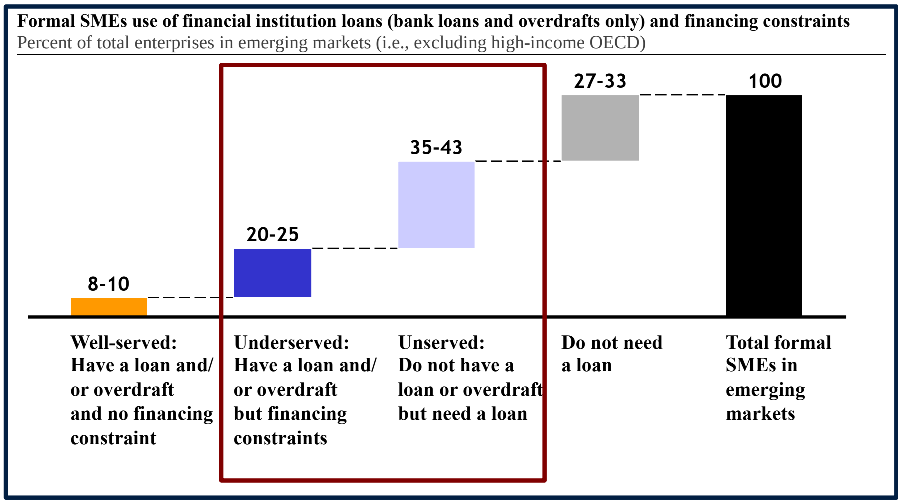
Access to finance is therefore a global challenge for both developed and developing countries and needs to be addressed more thoroughly from policy makers, the private sector, researchers and development agencies, especially with regards to creating prosperity and opportunities. Special focus should be granted to entrepreneurs that are collectively capable through innovative and high growth startups of significantly contributing to the economic growth, job creation and welfare of their respective countries and regions.

This enormous financing gap imposes great challenges that need to be met through innovative and diverse financial product offerings improving access to finance for SMEs on a global scale.

Therefore, the growing importance to overcome the financial access challenge of SMEs and startups due to their potential socioeconomic impact is a specical focus of the G20 under the themes of growth, long-term investments, and financial inclusion**.**

[4] Source: IFC Finance Gap Database (2011)

Figure 1.1: Percentage of Formal SMEs Underserved in Emerging Markets[5]



The long-term commitment of the G20 towards financial inclusion of SMEs is evidenced through defining the 'G20 Principles for Innovative Financial Inclusion' which has been founded by the G20 to promote access to finance.

Within the G20 presidency of Turkey in 2015, a number of priorities related to SMEs have been defined and can be summarized as follows[6]:

- Achieving inclusiveness both on a domestic and global scale to ensure that growth and prosperity are shared by all segments of society including the SMEs,
- Unlocking investments and introducing reforms to unlock private sector investments for SMEs,
- Establishing a World SME Forum to voice the expectations and concerns of SMEs to B20 and the governments of the G20,
- Supporting the integration of SMEs, especially in developing countries, into global value chains,
- Promotion of non-traditional sources of financing (equity-based and asset-based) for SMEs,
- Working on innovation and technology as promising initiatives for SMEs.

In order to support these priorities, especially in terms of increasing and diversifying the sources of financing for SMEs, one possible area is to identify the strength and potential of

[5] Source: IFC Enterprise Finance Gap Database (2011)

[6] Sources: (1) Turkish G20 Presidency Priorities for 2015
(2) Global Partnership for Financial Inclusion (2015) – Turkish 2015 Priorities Paper

participatory finance such as Islamic finance through which asset-based and equity-based financing can be provided for SMEs in G20 as well as developing countries.

Including innovation and technology in the agenda, reflects the importance of employment of Islamic finance and its instruments beyond SMEs to tackle the specific characteristics and features of innovative seed, early-stage and growth-stage startups as a catalyst for innovation-driven economies and growth. Therefore the role of asset-based and equity-based financing for SMEs and startups is crucial to unleash the entrepreneurial potential both in developed and Emerging Markets and Developing Countries (EMDCs) due to the positive implications SMEs and specifically high-growth startups and their entrepreneurs have on economic growth, youth empowerment and socioeconomic development.

Within this context, Islamic banking and finance is one of the priority topics for Turkey's current presidency of the G20 in 2015, these efforts should not be evaluated based on Turkey having a majority Muslim population, but should instead be assessed objectively as an ethical alternative source of financing to enhance growth, long-term investments and financial inclusion for G20 members and developing countries irrespective of the label attached to it.

1.2 Islamic Finance: A Catalyst for Inclusive Growth

Since its modern history emergence in the 1970s, Islamic banking and finance has shown unprecedented global success in terms of growth, expansion, institutional and product diversification (*see Table 1.2*). Over the last five years, the Islamic banking and finance industry grew by a compound annual growth rate of about 17%, reaching more than US$1.87 trillion in total assets in the first half of 2014 (IFSB, 2015). Additionally, according to the same report, the Islamic banking sector grew by 16% in 2013 compared to the overall global banking growth (based on the assets of the top 1000 global banks, which grew by only 4.9% in 2012 and 0.6% in 2013).

Table 1.2: Islamic Banking and Finance Assets in 2014 in US$ billion[7]

Region	Islamic Banking Assets	*Sukuk* Outstanding	Islamic Funds Assets	*Takaful* Contributions	Total
Asia	203.8	188.4	23.2	3.9	419.3
GCC	564.2	95.5	33.5	9.0	702.2
MENA (excl. GCC)	633.7	0.1	0.3	7.7	641.8
Sub-Saharan Africa	20.1	1.3	1.8	0.6	23.8
Others	54.4	9.4	17.0	0.3	81.1
Total	**1,476.2**	**294.7**	**75.8**	**21.4**	**1,868.1**

As can be seen in the table above (*Table 1.2*), the contribution from Sub-Saharan Africa and other regions (particularly Europe), remains relatively low, although the future growth

[7] Source: IFSB (2015)

prospects are promising based on recent developments and initiatives in several new and niche Islamic finance markets within these regions (IFSB, 2015).

The Islamic banking and finance industry is backed by almost 400 Islamic financial institutions[8] operating in more than 70 countries including countries outside the OIC such as the United Kingdom, the United States, Luxembourg, Mauritius, Singapore and Germany. In 2015, the first Islamic bank operating in Germany has been launched. Additionally, a large number of conventional financial service providers such as asset managers are active in the Islamic fund industry through managing *Shariah-compliant* discretionary portfolios on behalf of *Shariah*-sensitive institutions and individuals mainly residing in the GCC. These portfolio information is not made public but is estimated to add another US$ 67 billion to the Islamic finance assets (Asutay and Marzban, 2015).

Even though the Islamic banking and finance industry is still relatively small in terms of size compared to conventional finance, its growth rate and increasing global outreach is indicative of the potential this industry can reach in the long-term.

The growth witnessed in Islamic finance assets is widely criticized for limiting its services to a high extent for high-net worth individuals and mimicking conventional debt financing rather than significantly contributing to social and economic development via 'asset-based' and 'equity-based' transactions with risk-and-profit sharing nature (Marzban and Asutay, 2014).

From a *Shariah* perspective, the foundational philosophy of Islamic finance relies heavily on the economic and social development factor including financial inclusion in the form of servicing the un-bankable of the society – such as SMEs (Asutay, 2012). **According to Haneef (2005), Islamic economics is an *"approach to, and process of, interpreting and solving the economic problems of human beings based on the values, norms, laws and institutions found in, and derived from the sources of Islam*"**.

The concept of inclusive growth in Islam is further evidenced strongly as stated by Imam Al-Ghazzali:

> *"The objective of the Shariah is to promote the well-being of all mankind, which lies in safeguarding their faith, their human self, their intellect, their posterity and their wealth. Whatever ensures the safeguard of these five serves public interest and is desirable."* (Chapra, 2000)

One of the priority areas identified by G20 for 2015 is achieving inclusiveness to ensure growth and prosperity are shared by all segments of society, which is supported by the above statement which emphasizes that well-being is to be promoted for all mankind – both Muslims and Non-Muslims.

[8] Source: World Bank Islamic Banking Database (2014)

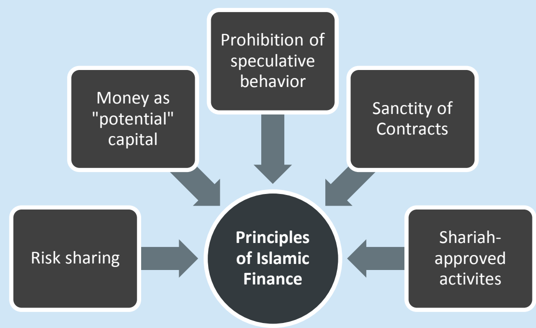
According to Mohieldin, Iqbal, Rostom and Fu (2012), the core principles of Islam empasize social justice, inclusion and sharing of resources. In the case of SMEs, financial inclusion can be addressed by Islamic finance through promoting risk-sharing contracts as a viable alternative to conventional financing.

The relevance of *Shariah-compliant* SME financing and its' risk-sharing characteristics from an economic development perspective have been recognized by various policy makers in different countries and international bodies such as the OIC who in a special work group related to SMEs in 2012 defined as its main target to *"develop appropriate policies to accelerate the convergence between Islamic finance and SME industires. In this context, promote the use of Islamic finance products, which are more linked to the real economic activity, to enable SMEs in the member countries to tap into the rapidly growing pool of Shariah-compliant funds."*

Box 1.1: Principles of Islamic Finance

The principles of Islamic Finance are derived from a set of rules based on the *Shariah* and interpreted through the Quran, Sunnah and from ellaborative efforts of *Shariah* Scholars.

The basic principles of an Islamic financial system are summarized by Iqbal (1997) as follows:



Risk sharing. Providers of financial capital and the entrepreneurs should share business and financial risks in return for shares in the profits. Islam encourages the earning of profits but prohibits the interest-based debt because profits, determined *ex post*, symbolize succesful entrepreneurship and creation of additional wealth whereas interest, determined *ex ante*, is a cost that is accrued irrespective of the outcome of business operations. Social justice demands that borrowers and lenders share rewards as well as losses in an equitable fashion.

Money as "potential" capital. Money is treated as "potential" capital – that is, it becomes actual capital only when it joins hands with other resources to undertake a productive activity. Islam recognized the time value of money, but only when it acts as capital, not when it is "potential" capital.

Prohibition of speculative behavior. An Islamic financial system discourages hoarding and prohibitis transactions featuring extreme uncertainties, gambling, and risks.

Sanctity of contracts. Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard.

***Shariah*-approved activities.** Only those business activities that do not violate the rules of *Shariah* qualify for investment. For example, any investment in businesses dealing with alcohol, gambling, and casions would be prohibited.

Source: Iqbal (1997)

1.3 Demand and Supply of Islamic SME Finance

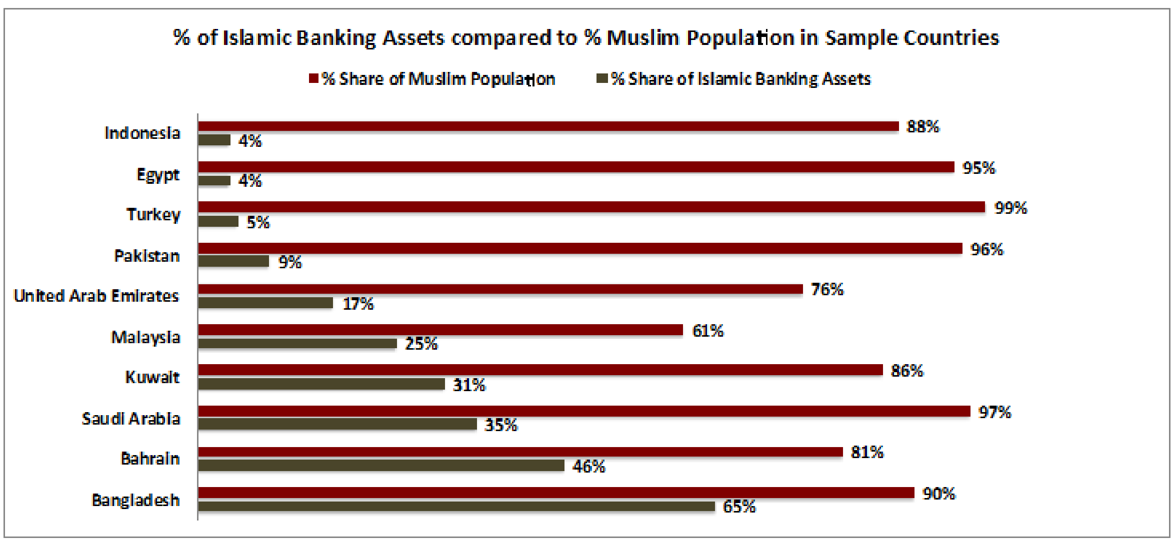
The demand and supply for Islamic finance and Islamic SME financing specifically has to be analyzed from various perspectives to put it into context with the factors related to innovative financial solutions tackling financial inclusion, benefiting from potential investment opportunities as well as serving a growing Muslim population and their *Shariah* preferences.

Muslims represent about 23% of the global population (1.6 billion in 2010) and are expected to reach 30% with 2.2 billion adherents by 2030 (Population Reference Bureau, 2011). Islamic banking and finance on the contrary represents less than one percent of global financial assets.

The under-representation of Islamic financial assets compared to conventional financial assets is also witnessed within Islamic countries, especially if compared to the percentage of Muslims residing in the respective countries (see Figure 1.2).

Within the context of the G20 member countries, it is important to note that Muslims within G20 total about 556 million people representing 12.5% of the total G20 population. If only G20 member countries with a minority Muslim population is considered (excluding Indonesia, Saudi Arabia and Turkey), still 5.5% of the respective population are Muslims, thus representing a significant proportion of the overall population.

Figure 1.2: Sample Countries - % of Islamic Banking Assets and % of Muslims[9]



Of course the above figures cannot be a direct reflection on the demand for Islamic finance in Islamic countries or G20 countries since being a Muslim does not necessarily imply a demand for Islamic finance products but it still reflects the necessity to further research the demand for Islamic finance products for Muslims residing in G20 countries.

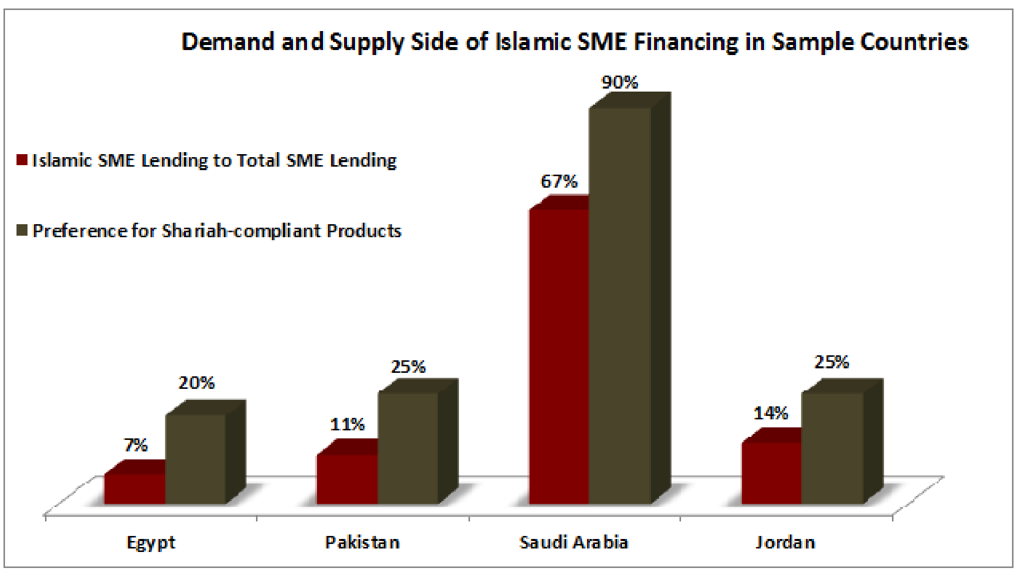
[9] Source: SESCRIC (2012)

Various research has been conducted to quantify the demand for *Shariah-compliant* financing with a focus on Islamic countries. A recent study conducted by the IFC (2014) focuses on Islamic banking opportunties across SMEs in MENA. This study, which focuses explicitely on SMEs, indicates that the proportion of Islamic SME financing to total SME financing for the sample countries researched is significantly lower than the preference for *Shariah-compliant* products defined within these countries.

So *Shariah-compliant* SME loans (*see Figure 1.3*), for instance, represent only 7% of the total loans in Egypt, whereas the demand for Islamic financial products is about 20%. Saudi Arabia is the country with the least gap between demand (90%) and supply (67%), due to the large number of Islamic banks residing in Saudi Arabia. It is estimated that about 32% of SMEs across the MENA region in addition to Pakistan are totally excluded from access to finance, mainly because of the lack of *Shariah-compliant* products. The "risk averse" approach of banks and specifically Islamic banks has led to a narrow product range offered to SMEs in these countries.

Several SMEs are seeking exclusively Islamic banking products to meet their financing needs and would not opt for conventional banking products due to the lack of *Shariah*-compliance (IFC, 2014). The demand problem is further magnified when assessed from the supply side where the average share of the MENA banks portfolios made up of SME lending is only 7.6%, as lending activities are mainly focused on large corporate customers and and government bonds (Nasr and Rostom, 2013).

Figure 1.3: Demand and Supply Side of Islamic SME Financing[10]



Financial inclusion should be about not excluding individuals or institutions from accessing financial products due to their religious or cultural preferences. Therefore, *Shariah*-sensitive individuals or institutions should not be disadvantaged due to the fact that they are only willing to deal with *Shariah-compliant* funding alternatives.

[10] Source: IFC (2014)

According to Khan (2015), policy focus on financial inclusion does not support faith-based preferences. Policies to overcome financial exclusion consider religious preferences as a voluntary cause of exclusion and therefore the G20 agenda should consider "faith-based barriers" a target policy to overcome exclusion of SMEs since from an Islamic perspective these barriers are involuntary and are supported through the development and offering of *Shariah-compliant* products.

Irrespective of the labeling of Islamic finance, based on the core values of promoting economic development through a portfolio of asset-based and equity-based financing solutions, a clear financing gap for SMEs can be tackled and served through Islamic banking and non-banking financial services. Attracting foreign investors such as GCC investors to invest in SMEs and startups residing in G20 countries is a clear opportunity to increase potential access to finance in the market. According to Booz & Co (2011), about a third of GCC investors prefer Islamic products over conventional products based on ethnicity and investment style. An additional indicator to the relevance of *Shariah*-compliance to GCC investors is reflected in *Table 1.3*, indicating that 64% of public funds assets under management in the GCC are *Shariah-compliant* and in the case of Saudi Arabia even almost 85% of the funds assets under management.

According to Asutay (2010), the development of Islamic banking and finance in Europe is attributable to two main reasons, which are the prevention of financial exclusion of Muslims in Europe and to attract large capital inflow from the GCC region.

Table 1.3: The GCC Fund Management Industry[11]

	Conventional Funds		*Shariah-compliant* Funds		Role of *Shariah-compliant* Funds
	No. of Funds	**Amount (in $m)**	**No. of Funds**	**Amount (in $m)**	**% of *Shariah* Funds in Total Amount**
Saudi Arabia	38	2,655	74	14,795	84.79%
Kuwait	28	3,389	19	921	21.37%
Qatar	9	328	3	20	5.75%
The UAE	15	501	3	85	14.51%
Oman	5	83	0	0	0.00%
Bahrain	1	18	0	0	0.00%
GCC/Mena	79	2,498	54	1,178	32.05%
Total	**175**	**9,472**	**153**	**16,999**	**64.22%**

Another important factor that can increase supply for *Shariah-compliant* financing products is to deepen the understanding of Islamic finance as a facilitator towards asset-based and equity-based financing so that similarities and differences with the conventional financial products based on the same principles can be identified and adjusted to serve both a wider range of investors and SMEs. This understanding will result in a clear differentiation of Islamic financial products compared with the interest-based conventional products. Furthermore, through redesign or financial re-engineering of existing conventional asset-based and equity-based financial

[11] Source: Markaz GCC Asset Management and Investment Banking Report (2012)

products could be made *Shariah compliant* which would have a positive implication of serving the now financially excluded Muslims, and offering new set of financial products to non-Muslims, and most importantly these offerings could increase liquidity for SMEs by being backed by foreign Islamic investors. Examples can be found especially with asset-based and equity-based conventional non-banking financial services such as venture capital financing and leasing for instance which are very close to their *Shariah-compliant* counterparts.

Again, Islamic finance is primarily about ethics, which are promoted by all religions as well as ethical standards, hence there is no reason non-Muslims should consider themselves excluded to benefit from Islamic financial institutions.

A role model example is Malaysia, which is a largely diversified country with 60.4% Muslims, 19.2% Buddhists, 9.1% Christians, 6.3% Hindus and the rest belonging to other religious groups or unknown[12]. The chairman of a major German financial services group providing Islamic insurance (*Takaful*) products in Malaysia, states that *"there is nothing more powerful in the world than an idea whose time has come. Islamic finance is not a Muslim-only affair. It shows qualities, which are beneficial to all kinds of customers. For all the Shariah-compliant products we sell in countries such as Malaysia, some 70 percent of our clients are non-Muslim"*[13].

In a research conducted in 2010, Muslims and Non-Muslims in Malaysia were asked a number of questions regarding their perception towards Islamic Banking and Finance[14]. The survey revealed that 64% of Non-Muslims rank as a top priority the products and services offered by Islamic banks as the main attracting element whereas for Muslims, the top priority is religion and adherence to their religious principles. Additionally, a total of 95% of the participants surveyed either strongly agree, agree or are neutral in that Islamic banking and finance does not conflict with their religious beliefs.

1.4 Islamic SME Financing Options

Islamic finance, through acting as an alternative and ethical financing method, targets to provide funds to impact-oriented real economic activities through the utilization of economic and financial resources to satisfy material and social needs of all members of the community – including SMEs and innovative startups.

The asset-based transaction nature together with the equity-based risk-and-profit sharing nature comprise the main foundations of Islamic financial products. Asset-based financing

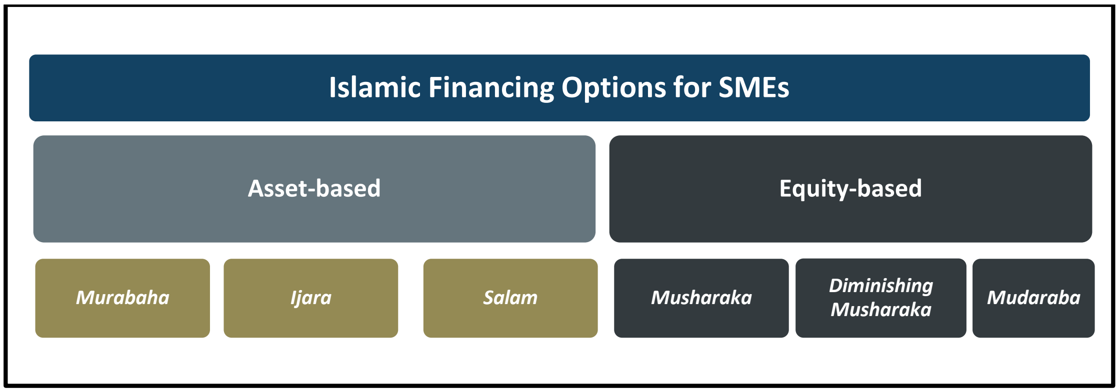
[12] Source: The World Fact Book on Malaysia

[13] Source: Mushtak Partner, "Islamic finance without innovation is dead", Arab News, April 2011

[14] Source: Mark Loo, "Attitudes and Perceptions towards Islamic Banking among Muslims and Non-Muslims in Malaysia", International Journal of Arts and Sciences, 2010

according to Askari, Iqbal and Mirakhor (2014) fulfills a core requirement of Islamic financial transaction through ensuring that the financial transaction is part of a real economic activity with a close financial linkage to the financed assets ensuring less *"financilization"*[15] compared to interest-based transactions where assets are generally not part of the financial transaction and serve solely as collaterals. Equity-based financing on the other hand promotes profit-and-loss sharing between financiers and entrepreneurs resulting in increased alignment of interests, increased risk sharing and fostering entrepreneurship especially of seed and early-stage startups, which rely purely on equity financing for their ventures.

Figure 1.4: Islamic Financing Options for SMEs



As can be seen in *Figure 1.4*, the Islamic financing options for SMEs identified can be divided into two broad categories distinguishing between asset-based and equity-based financing options.

Each of these financing categories have a fundamental role in the enhancement of financial inclusion of SMEs and innovation startups as well as the attraction of potential capital from Islamic capital providers and sources.

It is important to mention that there do exist other Islamic financing models such as fee-based models like *Wakala* and *Kafala*. *Kafala*, for instance, means guarantee, can and is utilized in the context of Islamic financial SME transactions as is shown in Chapter three of this research.

All these financing options are designed to be based on *Shariah* principles (*Shariah*-based), whereas there exists a wide spectrum of conventional financing options which can still be considered *Shariah-compliant* if they pass specific criteria.

Thus, other financing options include SME funds, a few Venture Capital and Private Equity funds, crowdfunding platforms and angel investment networks as well as other equity-based

[15] The authors define financilization as the *"growth of pure financial instruments, completely detached from the real sector and having a life of their own"*

financing options which have to be screened on a case-by-case basis to ensure that business practices and transactions are in compliance with *Shariah* or not.

1.4.1 Asset-based SME Financing Instruments

Asset-based (including sale-based such as *Murabaha*) financing is the most commonly used financing option by Islamic banks especially in terms of *Murabaha* followed by *Ijara*. Even though it is an asset-based financing mechanism, *Murabaha* financing is a dominant financing mechanism by Islamic banks, especially due to the fact that it is relatively easy to implement, utilizes same credit criteria for entrepreneurs as compared to conventional financing, and is utilized to mimic the return and risk characteristics of conventional loans. In the MENA region, for instance, the proportion of *Murabaha* financing to total Islamic financing is about 75 percent in 2008 (Ali, 2011)[16].

The following Islamic financial products described below are subject to a number of *Shariah* requirements to fulfill their compliance, which are not further elaborated within the context of this research.

1.4.1.1 Asset-based SME Financing – *Murabaha*

As can be noted in *Table 1.4*, the understanding of Islamic financial transactions and financial literacy are relevant to increase demand and common acceptance of *Murabaha* as an Islamic financial instrument for SMEs[17].

In *Murabaha*, from a pricing perspective, the cost is to a large extent at par value with conventional financing whereas the procedures and time-related risk ownerships (such as within the time window the financier owns the asset) as well as the use of penalties in the case of delayed payments or defaults (an Islamic financier cannot benefit from these penalties as they have to be directed towards charity) are the core determinants of the compliance of the instrument offered.

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[16] A number of global initiatives, such as the ones promoted by CGAP and IDB in 2013, have started using competitions to drive innovation in the development and implementation of Islamic financial products going beyond *Murabaha* especially in the area of microfinance. To objective is to promote mainly equity-based financing through *Musharaka*, *Diminishing Musharaka* and *Mudaraba*.

[17] Similar issues in terms of the lack of financial literacy and understanding of *Murabaha* as an Islamic financial model has been also witnessed in the microfinance industry as indicated by CGAP (2008) that *"although there is ample evidence of demand for Islamic microfinance products, this demand can only be met if low-income clients are convinced that the products offered are authentically Islamic. Critics of Islamic finance products suggest that the pricing of some products offered as Shariah-compliant too closely parallels (or even exceeds) the pricing of conventional products. For example, some institutions offering Murabaha seem to disguise interest as a cost markup or administration fee."*

From an access to finance perspective for SMEs and startups, *Murabaha* is expected to fill partially the *Shariah* consciousness gap but not to contribute significantly in closing the financing gap of SMEs and startups that lack access to funding due to their specific needs or caused by their lack of collaterals or credit history, which is usually requested by Islamic banks similar to a conventional debt transaction.

Therefore Islamic banks should be encouraged to move their portfolio concentration from the provision of mainly *Murabaha* to other asset-based and equity-based financing instruments to meet the actual demands and characteristics of SMEs and startups.

At the same time, the Islamic banks reluctance to do so opens opportunities for a wide range of non-banking financial services providers to compete with banks in providing adequate offerings to SMEs and thus to enhance financial inclusion.

Table 1.4: *Murabaha* SME Financing Fact Sheet

Islamic Financial Product	*Murabaha*
Definition	A *Murabaha* is a contract between a financier and a client through which the financier purchases assets required by the client and then sells them to the client at a cost that includes a disclosed profit margin to be paid back, usually in installments.
Benefits for SMEs and Startups (other than being *Shariah-compliant*)	For SMEs • Fixed financing rate during financing term • Full price and mark-up transparency • Useful for short-term financing • SME and management remain independent • Ideally overcomes collateral requirements through enforcing sale of asset in the case of default
Financial Institution(s)	• Mainly Islamic Banks • *Murabaha* Funds
Opportunities	• Limited to meet demand of Islamic oriented SMEs and the Muslim population in G20 countries • Limited to meet demand for *Shariah-compliant* financing in EMDCs through increasing number of Islamic banks, their portfolios and outreach
Potential Key Enablers	• Islamic Banks • Islamic Development Bank • Domestic Development Institutions • Regulators (Tax regulation)
Main Challenges	• Islamic financial literacy since a large fraction of Muslims perceive *Murabaha* similar to conventional interest due to mark-up benchmarking • Over-utilization of *Murabaha* by Islamic financial institutions instead of offering other products to mimic the characteristics of conventional financial products

	• Since the asset transfer occurs twice in a *Murabaha* transaction thus resulting in double taxation compared to conventional financing • The profits of the *Murabaha* could be taxed as a capital gain also disadvantageous compared to conventional financing

1.4.1.2 Asset-based SME Financing – *Ijara*

Ijara **on the other hand (*see Table 1.5*) is a *Shariah-compliant* financing product beneficial for both SMEs and startups since the main criteria for eligibility for financing is the ability to generate cash flows serving the lease rather than submitting collaterals and credit history**.

This is also aligned with the findings of Mohieldin et al (2012), who state that *Ijara* is widely used to finance SMEs as it reduces startup costs and provides additional security to lessors.

Table 1.5: *Ijara* SME Financing Fact Sheet

Islamic Financial Product	*Ijara*
Definition	*Ijara*, or Islamic leasing, is a transaction through which one party leases equipment, for instance, to be used by a client for an agreed upon rental fee. Another form of *Ijara* – *Ijara* wa Iqtina – is a lease to own, through which a financier leases assets to clients for an agreed rental fee with an additional unilateral undertaking by only one of the parties to buy or sell the asset at the end of the lease period[18].
Benefits for SMEs and Startups (other than being *Shariah-compliant*)	For SMEs and Startups • Enables financing even with the lack of collaterals and credit history since the lessor owns the assets and can repossess assets in the case of default • Useful for medium and long-term financing • Simple documentation and processes
Financial Institution(s)	• Islamic Banks • Islamic Leasing Companies • Some conventional financial leasing companies especially in MENA provide both conventional and Islamic leasing products increasing their outreach
Opportunities	• Serve Islamic oriented SMEs and startups • Support financial inclusion in EMDCs • Establishing Islamic leasing companies • Introduce Islamic Leasing companies in G20 as an ethical risk-sharing leasing alternative
Potential Key Enablers	• *Ijara* Management Company (ICD) • Regulators

[18] A comparison between a conventional lease and an Islamic lease based on IFC (2009) can be found in Chapter Two.

Main Challenges	• Lack of regulation in most developing countries for leasing and specifically Islamic leasing • Limited availability of medium and long-term funding especially for banks • Scarce human resources in leasing industry

The core challenges which need to be addressed are the lack of regulation for the leasing industry in general especially in developing countries and the importance to create funding channels for Islamic leasing transactions through banks and leasing companies, which are mainly financed through equity and thus present an excellent opportuntity for *Shariah*-conscious investors to diversify their investment portfolios.

1.4.1.3 Asset-based SME Financing – *Salam*

Even though *Salam* (*Table 1.6*) is an excellent mode of financing to provide working capital, it is almost not utilized due to the complexity of implementation involving the financier to act as a commodity reseller and the lack of expertise in the market. *Salam* should be further explored and supported as a mode of financing for farmers, especially for MSMEs in countries such as Sudan and Pakistan.

Table 1.6: *Salam* SME Financing Fact Sheet

Islamic Financial Product	*Salam*
Definition	*Salam* is a forward sale contract in which an advance payment is made for commodities (mainly agricultural crops) to be delivered at a future date. A *Salam* can thus be utilized to provide working capital to the SME.
Benefits for SMEs and Startups (other than being *Shariah-compliant*)	For SMEs • Provision of *Shariah-compliant* working capital • Beneficial for agricultural import and export • Useful for short-term financing
Financial Institution(s)	• Islamic Banks (few)
Opportunities	• Serve Islamic oriented SMEs in need of working capital especially in the agricultural sector • Support financial inclusion in EMDCs • Improve financial inclusion and access to finance
Potential Key Enablers	• Islamic Development Bank
Main Challenges	• Complexity of process especially for financier to enter into a Parallel *Salam* for selling the commodities • Lack of expertise and know-how in *Salam* among Islamic finance practitioners

1.4.2 Equity-based SME Financing Instruments

Increasing access to equity-based financing is important in both EMDCs as well as developing countries, where it is expected that by 2020 there will exist a global equity gap faced by corporations of US$ 12.3 trillion mainly attributable to the rise of wealth in EMDCs, aging population as well as growth of alternative investments (McKinsey Global Institute, 2011). Even though the direct implication is on large corporations listed on stock exchanges, innovative startups for instance would be highly affected since strong equity markets are a primary exit option for their primary financing source – venture capital funds.

According to the OECD, *"equity finance is key for companies that seek long-term corporate investment, to sustain innovation, value creation and growth. Equity financing is especially relevant for companies that have a high risk-return profile, such as new, innovative and high growth firms. Seed and early stage equity finance can boost firm creation and development, whereas other equity instruments, such as specialized platforms for SME public listing, can provide financial resources for growth-oriented and innovative SMEs."* (OECD, 2015).

This statement is highly aligned with the key characteristics of Islamic finance, which is encouraging partnership and risk sharing rather than risk transfer, thus ensuring a balanced relation between financiers and entrepreneurs.

1.4.2.1 Equity-based SME Financing – *Musharaka*

***Musharaka* (*see Table 1.7*), a straightforward partnership model, is a favorable option for SME financing which is almost non-existing due to the perceived risk of entering into a profit-and-loss sharing relation with SMEs and startups**. But *Musharaka* - if defined based on healthy and balanced capital contributions from the entrepreneurs and the financier - can result in appropriate risk mitigation.

There are a lot of commonalities between *Musharaka* and conventional Venture Capital / Private Equity funds in terms of the formal relationship and structure of the vehicle and therefore *Musharaka* could be easily adopted by conventional vehicles to attract capital from *Shariah*-conscious investors.

The Islamic Development Bank and the World Bank have both enabled the introduction and implementation of *Musharaka* for SME refinancing through different lines of credits and financing provided to developing countries such as Egypt and Jordan.

The key challenges of implementing *Musharaka* in addition to the high capital charges for Islamic banks are similar to conventional challenges faced by Venture Capital funds in developing countries, primarily to identify appropriate exit venues and secondary markets to exit the partnership within the specified investment horizon.

Table 1.7: *Musharaka* SME Financing Fact Sheet

Islamic Financial Product	*Musharaka*
Definition	*Musharaka* is a partnership agreement established by two or more parties where all provide capital into a joint venture to share its profits and losses. Profits are distributed among partners based on pre-agreed

	ratios while losses have to be borne by the partners proportional to their capital contribution.
Benefits for SMEs and Startups (other than being *Shariah-compliant*)	For SMEs and Startups • Profit and loss sharing • Ability to receive % of profits higher than entrepreneurs capital contribution • Useful for long-term financing
Financial Institution(s)	Few • Islamic Venture Capital and Private Equity Funds • Islamic Crowdfunding Platforms • Utilized by Apex institutions such as the Social Fund for Development in Egypt to enter into Islamic partnership agreements with Islamic banks financing SMEs
Opportunities	• Serve Islamic oriented SMEs and startups • Attract capital and excess liquidity for Islamic or conventional Venture Capital and Private Equity funds with parallel *Shariah* structures increasing access to finance to SMEs and startups • Catalyze entrepreneurial ecosystem • Reduce brain drain of domestic entrepreneurs from EMDCs
Potential Key Enablers	• Islamic Development Bank • World Bank • EBRD
Main Challenges	• High equity risk especially for Islamic Banks to deal with SMEs and startups • Exit scenarios through secondary markets and other channels • Human capital able to evaluate *Musharaka* opportunities feasibility

1.4.2.2 Equity-based SME Financing – *Diminishing Musharaka*

***Diminishing Musharaka* (*see Table 1.8*) is an innovative Islamic financial product**, capable to overcome shortcomings of financing instruments like *Murabaha* as well as *Musharaka*.

For financial institutions, the main advantage of the *Diminishing Musharaka* model is that it is an equity-based partnership model providing a clear exit and liquidation mechanism for the financier, which should not only encourage Islamic financial institutions and *Shariah-compliant* SME funds but should also motivate conventional funds to offer the product.

Table 1.8: *Diminishing Musharaka* SME Financing Fact Sheet

Islamic Financial Product	*Diminishing Musharaka*
Definition	*Diminishing Musharaka* is a *Musharaka* agreement where the entrepreneur promises to buy the investment shares of the other partner(s) over time until the entrepreneur owns 100% of the venture.

Benefits for SMEs and Startups (other than being *Shariah-compliant*)	For SMEs and growth-stage Startups • Profit and loss sharing and share buyback based on market rate • Ability to retain SME or startup over long run; especially important for family businesses • Useful for bridge financing; not giving up equity over medium / long-term
Financial Institution(s)	• Islamic Banks • Conventional financial institutions including banks and SME funds should utilize *Diminishing Musharaka* as an alternative source of equity participation with a clear exit scenario.
Opportunities	• Serve Islamic oriented SMEs and startups • Attract capital and excess liquidity for Islamic or conventional Venture Capital and Private Equity funds with parallel *Shariah* structures increasing access to finance to SMEs and startups in G20 • Beneficial for SMEs in G20 • Venue for SME funds with clear exit strategy • Should be utilized more frequently by Islamic Banks due to advantageous characteristics as compared to *Murabaha*
Potential Key Enablers	• Islamic Banks (Few) • Islamic Development Bank • World Bank
Main Challenges	• Complexity and cost of valuation at share repurchase and therefore used more for specific assets • Tax treatment • Legal documentation and registration of diminishing ownership

***Diminishing Musharaka* is a perfect fit for SMEs, especially those who are family businesses reluctant to give up ownership of the firm**. Other beneficiaries could be startups - at least in their growth stage – that are already generating profits to reduce the time span of the diminishing partnership. These respective entrepreneurs need capital to grow, are underserved from financial institutions but are reluctant to give up further equity.

The *Diminishing Musharaka* model might also be interesting for SME funds but not likely to be an added value to Venture Capital funds. Venture Capital funds are not interested in the share buy-back from the founders and are in for multiples of returns, which can only be achieved through mergers and acquisitions or an IPO. Therefore, this financing model is more applicable if perceived as a time-limited equity participation with the upside of receiving returns through dividends and an increase in the valuation of the business over time.

1.4.2.3 Equity-based SME Financing – *Mudaraba*

***Mudaraba* (*see Table 1.9*) is a model similar to conventional asset management, where asset managers invest on behalf of capital providers and receive a percentage of the realized return for services rendered**. A main difference between the Islamic and conventional model in the case of the *Mudaraba* is that through a *Mudaraba*, the *Mudarib* (manager) is not to be compensated through a management fee and thus his only return would be generated in the case profitability is achieved.

Table 1.9: *Mudaraba* SME Financing Fact Sheet

Islamic Financial Product	*Mudaraba*
Definition	*Mudaraba* is a partnership between a capital provider (Rab-ul-Mal) and an entrepreneur who is acting as fund manager (*Mudarib*). Profits may be distributed at any pre-agreed ratio, whereas losses are borne by the capital provider.
Benefits for SMEs and Startups (other than being *Shariah-compliant*)	For SMEs and Startups • Profit sharing only • No need to contribute capital into venture compared to *Musharaka* • Ability to negotiate % of profits • Useful for long-term financing
Financial Institution(s)	Few • Islamic Venture Capital and Private Equity Funds • Islamic Crowdfunding Platforms
Opportunities	• Serve Islamic oriented SMEs and startups • Attract capital and excess liquidity for Islamic or conventional Venture Capital and Private Equity funds with parallel *Shariah* structures increasing access to finance to SMEs and startups • Catalyze entrepreneurial ecosystem • Reduce brain drain of domestic entrepreneurs from EMDCs
Potential Key Enablers	• Islamic Development Bank • World Bank • Venture Capital and Private Equity Funds
Main Challenges	• Highest equity risk since other counterparts have “no skin in the game” in terms of capital contribution • Exit scenarios through secondary markets and other channels • Human capital able to evaluate feasibility of *Mudaraba* opportunities

This could result of course in the *Mudarib* or acting entrepreneur to expose the capital provided to excessive risk and therefore there exist two forms of *Mudaraba*: Unrestricted *Mudaraba* and Restricted *Mudaraba*. An Unrestrictive *Mudaraba* is a contractual agreement in which the capital provider permits the *Mudarib* to manage the *Mudaraba* capital without any restrictions. While within a Restrictive *Mudaraba*, the capital provider is capable to define clear guidelines in terms of risk exposure and use of capital, for instance, ensuring that the capital investment is aligned with his/her investment philosophy and risk preferences.

A core difference between *Mudaraba* and *Musharaka* is that in a *Musharaka* all partners are entitled to participate in managing the *Musharaka* venture, while in the *Mudaraba* there is clear seperation between the capital provider and the *Mudarib* who is the one solely entitled to manage the *Mudaraba* business based on the agreed upon restricted or unrestriced *Mudaraba* agreement.

***Mudaraba* is of course a favourable financing option for startups and SMEs firstly due to the ability of the entrepreneur to manage the funds solely and secondly due to the shift of the risk towards the financier**.

In general, Islamic banks are not providing *Mudaraba* financing to SMEs and startups due to high risk considerations. Venture capital funds, both conventional and Islamic, are or can be based on *Mudaraba* by providing capital to startups and carrying the full risk which generally needs to be mitigated through a Restricted *Mudaraba* agreement and enforcing corporate governance and board representation for monitoring and evaluation.

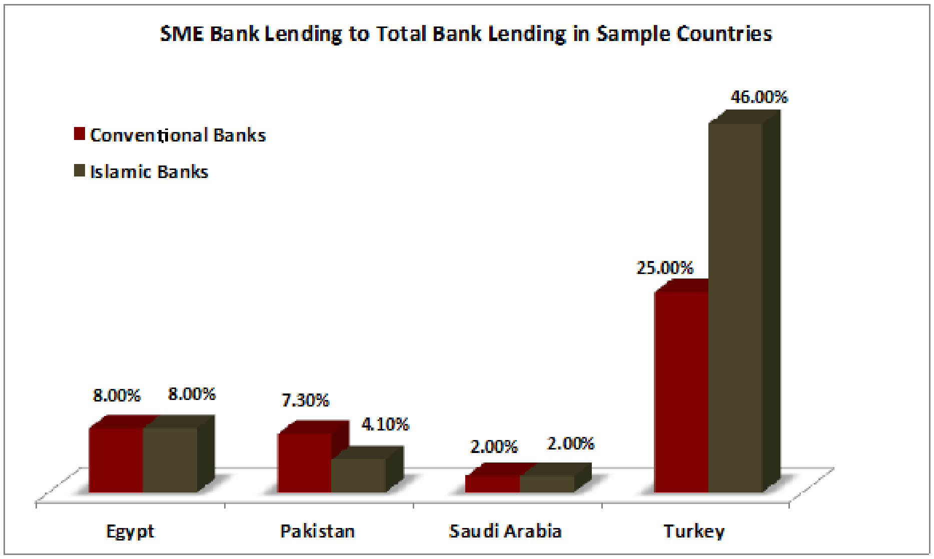
1.5 The Unmet Demand of SMEs by Islamic Banks

Islamic banks similarily to conventional banks failed to serve SMEs and startups due to the perceived risks, lack of collaterals and sufficient credit history. While Islamic banks could rely on various asset-based and equity-based financing instruments their main exposure is through asset-based financing in the form of *Murabaha*. Even though it is an asset-based financing mechanism, *Murabaha* financing is a dominant and preferred financing mechanism by Islamic banks, especially due to the fact that it is relatively easy to implement, utilizes same credit criteria for entrepreneurs as compared to conventional financing, and is designed to mimic the return and risk characteristics of conventional loans. In the MENA region, for instance, the proportion of *Murabaha* financing to total Islamic financing as previously mentioned is about 75 percent in 2008 (Ali, 2011)[19].

The unmet demand of SMEs through Islamic banks is mainly attributable to the failure in extending profit-and-loss sharing equity-based financial instruments such as *Musharaka* and *Mudaraba* to SMEs disregarding the core principles advocated by Islamic finance and representing a lost opportunity to financially include SMEs underserved by interest-based banking providers. This unmet supply or appetite by Islamic banks is not as perceived only a matter of risks anticipated with SME financing but also a result of depositors expectations and the lack of sufficient human capital capable to structure and manage such equity-based financing instruments.

[19] A number of global initiatives, such as the ones promoted by CGAP and IDB in 2013, have started using competitions to drive innovation in the development and implementation of Islamic financial products going beyond *Murabaha* especially in the area of microfinance. To objective is to promote mainly equity-based financing through *Musharaka*, *Diminishing Musharaka* and *Mudaraba*.

Figure 1.5: SME Bank Lending to Total Bank Lending in Sample Countries[20]



While SME bank financing as a percentage of total private sector lending is relatively small for both conventional and Islamic banks in Saudi Arabia, Pakistan and Egypt, it can be noted that banks in Turkey in general have a much higher exposure to SMEs (*see Figure 1.5*). Most significant is that the Turkish Islamic banking sector (46%) has almost double the SME lending portfolio to total lending portfolio compared to conventional banks (25%). Even though this difference is partially attributable to the different classification definitions of SMEs in the respective countries, the Turkish SME financing model should be further researched and considered as a potential role model to be replicated across EMDCs.

1.6 Islamic SME Banking Challenges and Recommendations

Similar to conventional banking, Islamic banking does not significantly contribute to financial inclusion in its respective markets of operation, neglecting the core value proposition of Islamic finance as an ethical and social-responsible financing alternative to create welfare for the overall society. According to Ben Naceur, Barajas and Massara (2015) in a research published by the IMF, the data analysis revealed no significant impact for Islamic banking on financial inclusion.

This result is expected, considering the notable manner Islamic banks, its shareholders and clients compare Islamic banks to conventional banks in terms of risk, return and liquidity considerations. This is indicative in the asset composition of Islamic banks, which is highly concentrated in *Murabaha*, for instance, which as previously explained does not significantly contribute to financial inclusion, except from a religious perspective, compared to conventional financing.

[20] Source: IFC (2014) and World Bank (2014b)

Even though the significant growth of Islamic finance has attracted developed countries in the West to create Islamic finance hubs and adopt strategies supporting Islamic financial transactions, these efforts have mostly been driven by the objective to attract *Shariah*-sensitive capital rather than focusing on the developmental impact Islamic finance can and should have on financial inclusion and the promotion of fair and balanced financial transactions.

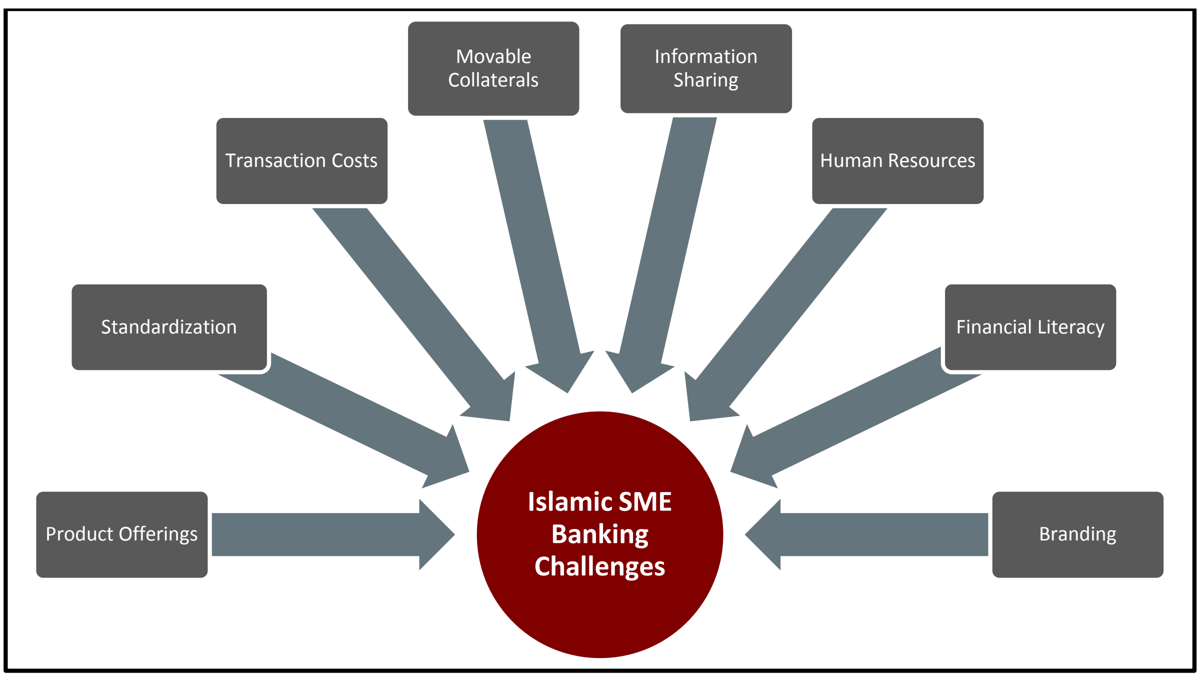
Therefore, to reach the full potential of Islamic finance in terms of addressing a mass market and improving financial inclusion, a paradigm shift is essential to ensure that the core values and growth of Islamic finance are achieved.

The potential of Islamic banks for financial inclusion within developing and developed countries is faced with a set of specific challenges, which need to be addressed by their respective stakeholders.

Challenges specifically constraining Islamic SME finance that need to be addressed in order to improve financial inclusion are discussed in the following (*see Figure 1.6*).

Regarding topics such as improving regulatory insight, liquidity management and the impact of Basel III on Islamic banks, these are relevant challenges impacting Islamic banks in general but are not specific to Islamic SME financing.

Figure 1.6: Islamic SME Financing Challenges



Product Offerings. Product offerings for SMEs from Islamic banks (except in some countries such as Indonesia or Pakistan) are significantly limited to debt-based financing such as *Murabaha*, although products such as *Ijara*, *Musharaka*, *Mudaraba* and *Diminishing Musharaka* are more appealing for specific financing needs and strongly promote the profit-and-loss sharing foundations of Islamic finance. The lack of diverse offerings for SMEs can be attributed to the risk perception of the Islamic banks as well as the limited exposure and know-how of their employees in structuring and managing such products. In a workshop funded by IDB in Egypt, and attended by representatives of Islamic banks to introduce them to alternative Islamic finance products, as most participants are currently only offering their clients *Murabaha* and *Ijara* financing without any exposure in *Mudaraba* or *Musharaka* for SMEs[21]. Empirical evidence of low exposure to *Mudaraba* and *Musharaka* has also been identified by Nagaoka (2007) and Asutay (2012).

Recommendations to Increase Product Offerings

- Practical education especially in Risk Management for equity-based financing
- Risk mitigation techniques and systems for equity-based financing
- Study tours and knowledge exchange
- Supporting the establishment of Non-banking financial services providing *Ijara* (Leasing companies), *Mudaraba* and *Musharaka* (Venture Capital companies)

Standardization of Contracts. **This is crucial for the evolvement of the industry. Standard setting bodies such as AAOIFI play a vital role in advancing the Islamic finance industry** and therefore the main challenge is the *Shariah* enforceability or the clear reliance of *Shariah* scholars on these practices, which would impact both client Islamic finance literacy and human resources development positively. Since Sharia compliance of Islamic banks is generally determined by a *Shariah* board , it is not infrequent to witness financial transactions and *Shariah* guidelines approved that are not fully in line with AAOIFI requirements, for instance. Increased standardization is healthy for comparability of offerings between different Islamic banks and building a common *Shariah* understanding and education for less experienced practitioners and SME end-clients. According to Mohieldin (2012), organizations like AAOIFI can lower entry barriers and could encourage conventional banks to utilize their existing networks in offering *Shariah-compliant* products.

Also efforts as the one conducted by the Malaysian Security Commission through having a centralized *Shariah* board and issuance guidelines as well as compliance status of listed securities in their stock markets supports standardization.

Recommendations to Support Standardization of Contracts

- Adaptation by Central Banks and Security Commissions and Authorities responsible for Non-banking Financial Services
- Criteria for *Shariah* board formations and *Shariah* scholars
- Centralized *Shariah* Boards and issuance of guidelines (such as Malaysian SC)

Transaction Costs and Taxes. **The asset-based nature of Islamic finance and the *Shariah*-compliance verification processes and requirements result in increased transaction costs to be bearded by the respective entrepreneur**. Additionally, the asset-based nature of the

[21] Workshop conducted by IDB Consultants and the Social Fund for Development in Egypt for Islamic Banks in 2014

transactions in the absence of specific tax treatments for Islamic financial instruments results in double taxation and increased cost compared to the conventional counterpart. Therefore taxation frameworks are essential to ensure tax neutrality so that Islamic finance transactions are exposed to the same level of taxation as their equivalent conventional counterparts. In the case of equity-based financing such as *Musharaka* and *Mudaraba* where net collaterals and credit history are determinants of the financing decision, the cost of in-depth due diligence and conducting or verifying feasibility studies also results in an increased transaction cost.

Recommendations to Reduce Transaction Costs and Taxes

- Increased standardization and information sharing will reduce cost
- Knowledge hub for standard Islamic financial documentation
- Taxation frameworks and laws for tax neutralization of Islamic financial instruments

Movable Collaterals. **One of the key challenges with respect to access to finance faced by SMEs is the lack of or unsuitability of existing collaterals**. According to De La Campa (2010), 78 percent of assets of businesses in developing countries are movable assets in the form of machinery, equipment and vehicles. Banks are reluctant to utilize movable assets of SMEs as collaterals due to the lack of reliable legal frameworks and collateral registries.

A legal framework that allows for the use of moveable collateral can significantly enable SMEs to leverage and maximize the economic potential of their movable assets facilitating their access to finance, and in the same time increase the offering of asset-based lending products for SMEs. A detailed analysis and recommendations to resolve the issue of movable assets from a regulatory and Islamic law perspective is covered in Chapter Two.

Recommendations to Improve Use of Movable Collaterals

- Legal framework for secured transactions including movable assets
- Reliable collateral registries
- Claim enforcement mechanisms
- Capacity building and training on processes and systems

Information Sharing. **The lack of knowledge in Islamic finance from both practitioners and clients is a major drawback of the enhancement of Islamic finance.** Larger financial institutions such as Islamic banks are able to hire internal and external man power to provide the essential expertise to structure innovative financial products for instance whereas smaller non-bank financial institutions are not able to hire a *Shariah* board and Islamic finance professionals. Therefore information sharing is essential to grow Islamic SME financing in terms of providing educational material, case studies and most importantly contractual templates and operations manual to follow by smaller financial institutions willing to offer Islamic finance products.
Information and knowledge sharing would also contribute to cross-boarder experience exchange and innovation triggered through discussions and elaborations.

Recommendations for Increased Information Sharing

- Creating the SME Islamic Finance Forum Platform including standardized documentation, *Shariah* standards and operation manuals in multiple languages and based on different jurisdictions to support Islamic MSME financing
- Knowledge platform with interaction among practitioners
- Case studies database on platform including best practices

Human Resources. **A major challenge identified and often discussed within the industry is the lack of qualified human resources faced by banks aiming to offer Islamic financial products to SMEs.** The industry is lacking both *Shariah* personnel and Islamic finance professionals. *Shariah* personnel with knowledge both in *Shariah* and banking / finance operations are a scarce resource due to the essential multi-disciplinary know-how required to determine the compliance of modern financial transactions and financial engineering to ***Shariah* rules**. Similarly, banking professionals interacting with SMEs often do not have any experience in regards to Islamic finance and are thus offering products they either do not understand or do not believe in its value proposition.

A survey conducted by the Economist Intelligence Unit commissioned by Kuwait Finance House (2012) on about 400 managers and executives to determine factors that have an impact on the demand of *Shariah-compliant* products and services, revealed the following:

- Barriers to growth in markets for *Shariah-compliant* products and services:
  - 44% of respondents chose lack of professional management and awareness as strongest reasons
  - 42% chose as second strongest reason lack of convincing branding that products and services comply with *Shariah*
- Main reason that holds back growth of Islamic financial institutions:
  - 35% shortage of expertise in the industry

Therefore, the two previous challenges - Islamic finance literacy of clients and limited product offerings - are a direct result of the lack of experienced human resources since in the absence of relevant know-how, it is nearly impossible to engage in Islamic financial transactions beyond *Murabaha*, for instance.

Recommendations to Improve Capabilities of Human Resources

- Technical Assistance for Islamic banking / finance practitioners
- Case Studies and practical experience exchange mainly from GCC and Malaysia
- Study tours and on the job training
- Support formal and informal education programs with global / local universities
- Accredited "practical" localized programs for Islamic finance professionals

Islamic Finance Literacy. **There is a general lack of understanding regarding Islamic finance as compared to conventional finance.** Perceptions range from considering it as targeting social gifting, to being identical and just rebranding of conventional financial products and finally to being more expensive than conventional products due to the operational *Shariah* requirements.

Even in the case of profit-and-loss sharing models such as *Musharaka* and *Mudaraba*, a deeper understanding of potential beneficiaries from SMEs has to be communicated to ensure that they understand the responsibilities and duties attached to these models of financing options.

The Islamic finance industry is a key factor in these misperceptions due to the excessive use of debt-like instruments such as *Murabaha*, the high transaction costs attached to the financing as well as the lack of Islamic finance literacy of the financial institutions' staff members that interact with the public.

Research has revealed that 73% of respondents named *"lack of awareness of Islamic banking products and services"* as a very significant or significant challenge in developing the Islamic banking business in their jurisdictions (IFSB, 2014).

Recommendations to Improve Islamic Finance Literacy

- Multi-lingual Islamic Finance education platform
- Promotional material
- Training and workshops for staff members facing clients

Branding. **The labeling of Islamic banking could be a concern for both Muslims and Non-Muslims. It might be perceived as being Muslim-specific and could result in exclusion for Non-Muslims.** For Muslims, the lack of Islamic finance literacy could result in considering Islamic banks just rebranded conventional banks. Therefore, the branding of Islamic finance has to be focusing on its ethical value proposition, the concept of inclusion of all mankind as well as on solid Islamic financial instruments based on profit-and-loss sharing. In the Kuwait Finance House (2012) survey mentioned above, 42% chose as second reason for hindering growth of Islamic finance the lack of convincing branding that products and services comply with *Shariah*. Thus, branding is a critical challenge to be addressed.

Recommendations to Improve Branding

- Inclusive approach branding Islamic finance as Ethical finance, asset-based and equity-based financing
- Increase of equity-based financing with clients and showcasing success stories
- Creation of Islamic Finance or Ethical Quality Indexes

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CHAPTER 2

MOBILIZING NON-BANKING FINANCIAL CHANNELS

2.1 Non-Banking Financial Channels for SMEs

The mobilization of capital from non-banking financial institutions and capital markets is an opportunity to increase access to finance and to overcome the shortcomings of Islamic banks to provide SMEs with innovative and desired asset-based and equity-based financial products.

Islamic banks, similar to conventional banks, consider SMEs and startups as too risky due to the lack of collaterals and credit history as well as being restricted by regulatory requirements and their depositors' preferences.

Within this chapter, the role of International Development Organizations in advancing the Islamic finance industry and the initiation of innovative asset-based and equity-based financial products is discussed. This is followed by a thorough description of various financing instruments compliant with Islamic law that can be utilized to improve financial inclusion of SMEs and specifically innovative growth startups through Venture Capital funds, Private Equity funds, Angel networks as well as crowdfunding.

According to a research conducted by Yao (2014) published by the Fung Global Institute, there are four main channels to increase non-banking financial resources for SMEs:

- **Increasing the use of equity funding through venture capital funds and angels**
- **Creation of SME stock exchanges and markets**
- **Increasing non-banking supply chain financing such as leasing**
- **Use of guarantees**

Within this research, different non-banking financial services options based on asset-based and equity-based financing are explored and product structures compliant with Islamic law are introduced that could overcome the shortcomings of banks in serving SMEs and startups as well as being beneficial for SMEs and investors residing in developing and developed countries.

Asset-based financial services such as leasing and credit guarantees adhering to Islamic law are key enablers to meet the need of SMEs and to overcome the key risk challenges faced by financial institutions.

Additionally, since profit-and-loss sharing through equity-based financial instruments is highly encouraged by Islam, there exists a wide array of conventional non-banking financial instruments that can benefit from Islamic finance, as after meeting a set of *Shariah* guidelines and critiera they can be considered *Shariah-compliant* financing instruments.

Conventional equity-based financing options to be considered *Shariah-compliant* would benefit *Shariah*-conscious SME owners to access these funding options but most significantly would also benefit SMEs in general through attracting a much larger pool of potential Islamic investors backing these investment vehicles resulting in an increase in available capital and liquidity especially in secondary markets.

SME stock exchanges for instances are *Shariah-compliant* in nature in terms of equity participation in primary or secondary listings of SMEs, whereas the listed SME has to satisfy minimum requirements in terms of its business activities and financial structure to ensure *Shariah*-compliance and thus permissibility to attract Islamic investments through Islamic funds or *Shariah*-conscious individual investors.

Other options such as Venture Capital funds, Angel investments and crowdfunding which all mainly target innovative high growth startups are also closely linked to the concepts of *Musharaka* and *Mudaraba* as described above, and thus are close to the fundamental principles of Islamic finance through meeting a set of *Shariah* guidelines.

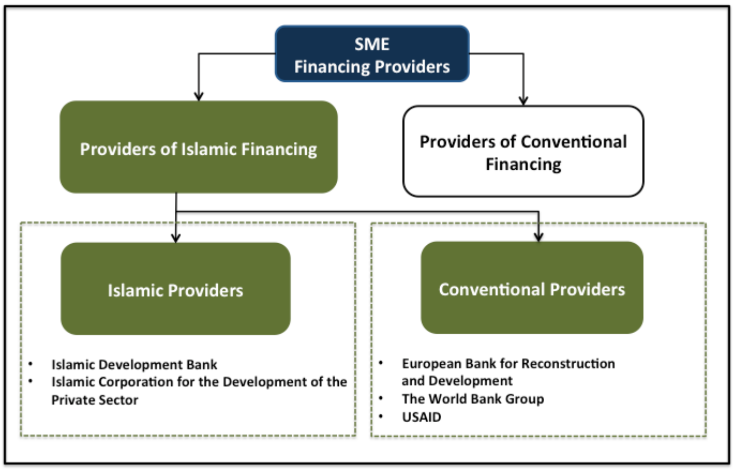
Within that context, institutional investors such as insurance companies, pension funds and mutual funds as potential financiers and capital source for SMEs and startups have to be further encouraged to increase the capital pool and to contribute to an increased diversification of the institutions' investment portfolios. Especially in the Venture Capital and Private Equity industry the role of institutional investors has been significant in increasing the access to capital for high-growth startups. According to Dow Jones, pension funds for instances contributed 20% of venture capital funds in the U.S. in 2014 indicating the significance of institutional investments in promoting entrepreneurship and as a source of portfolio diversification.

A detailed analysis of International Development Organizations as key enablers for such financing instruments, the different non-banking financing options and their potential to serve SMEs and attract Islamic investments as well as their compliance requirements are covered in the following sections.

2.2 International Development Organizations

International Development Organizations positevely contributed to evolving the Islamic finance industry, especially in OIC countries, over the last two decades. Even though most of the IDOs are not *Shariah*-based institutions and often provide the refinancing in the form of conventional loans, to meet the increasing demand of SMEs for Islamic finance in the target markets, the lines of credit are to be utilized in part through *Shariah-compliant* intermediates to ensure universal access.

Figure 2.1: IDOs as Islamic SME Financing Providers[22]



As shown in *Figure 2.1*, different IDOs active in providing Islamic financing for SME development can be either categorized as being purely Islamic refinancers or conventional refinancers while both target Islamic financing to be provided to end beneficiaries. Islamic refinancing sources stem mainly from the Islamic Development Bank or the Islamic Corporation for the Development of the Private Sector, whereas conventional refinancers targeting Islamic SME financing include for instance the World Bank Group and the European Bank for Reconstruction and Development.

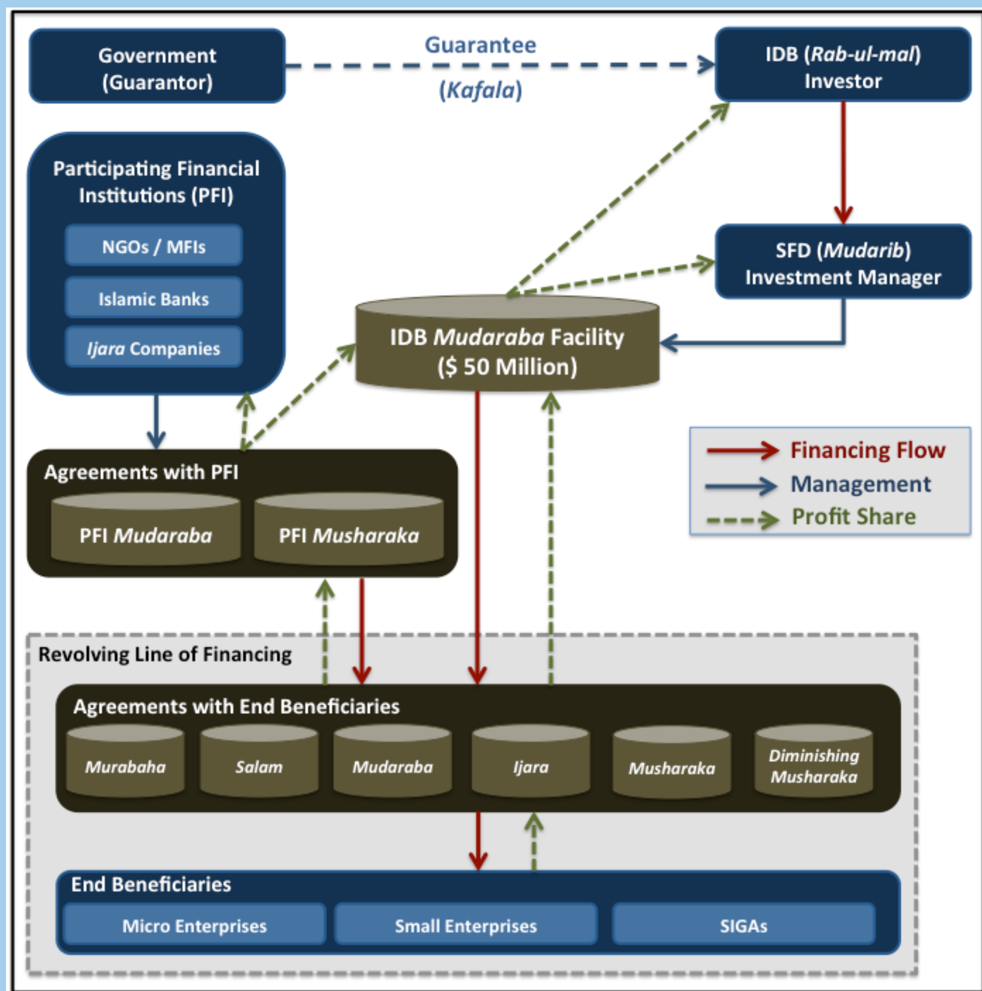
In the case of Islamic refinancers such as the Islamic Development Bank, a three stages Islamic financing process is implemented, through which the Islamic Development Bank for instance first enters into an agency contract through *Wakala* or *Mudaraba* with the implementing agency (a government institution or government guaranteed development organization), which would secondly pass on the financing to financial intermediates through agency or partnership models in accordance with Islamic law (such as *Wakala*, *Mudaraba* or *Musharaka*). Finally, in the third stage, the financial intermediary would enter into different Islamic financial contracts with the end beneficiaries based on the offerings of the financial institution and the financing

[22] Most programs offered through IDOs such as the World Bank Group or Islamic Development Bank provide financing support within the same program for both SMEs and micro-entrepreneurs

requirements of the beneficiary (such contracts generally include *Murabaha*, *Musharaka*, *Diminishing Musharaka*, *Salam* and *Ijara*).

Box 2.1: Islamic Development Bank – Youth Employment Support Program in Egypt[23]

Through the Youth Employment Support Program (YESP), the Islamic Development Bank provided financing to the Government of Egypt to support the Micro and Small Enterprise Development in Egypt through a Restricted *Mudaraba* Facility amounting to $50 Million. The facility is further supported by a Technical Assistance Grant to build the infrastructure and human resources of the implementing agency, the Social Fund for Development (SFD), and the financial intermediate in Islamic financial transactions.



As shown in the above structure, end beneficiaries are either financed directly through the *Mudaraba* Facility or through PFIs (NGOs, MFIs, Islamic Banks and *Ijara* Companies).

Especially in the case of NGOs and MFIs, capacity building and the provision of standardized Islamic financial contracts is crucial to spread highly-demanded Islamic financial products especially on the level of micro enterprises as surveys conducted with potential participating NGOs / MFIs revealed.

Additionally, the use of *Musharaka* with PFIs based on a 1:1 matching between the Social Fund for Development and the PFIs has proven to be a successful model of profit and loss sharing based on previous experiences of the SFD with Islamic banks.

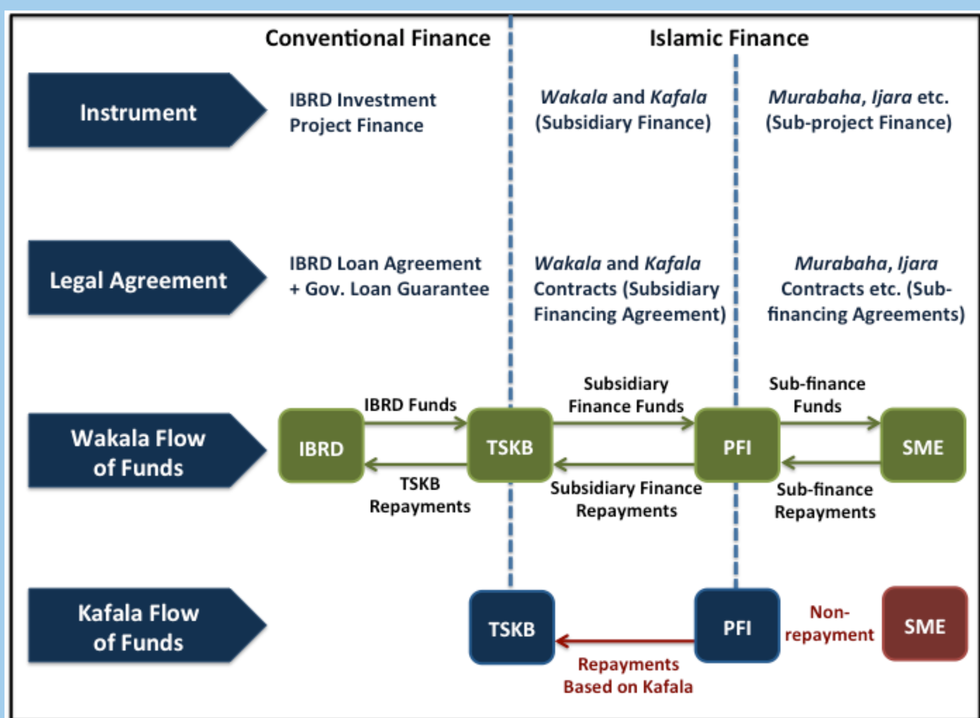
[23] Source: Compiled from IDB Project Appraisal Document, Project No. pEGt0136, October 2011

Box 2.2: World Bank – Long Term Finance for SMEs: Turkey's Access to Finance[24]

The World Bank is providing USD 250 million, out of which USD 160 million focus on Islamic finance to be intermediated by Türkiye Sınai Kalkınma Bankası A.Ş. (TSKB) through PFIs (Islamic banks are called Participation banks in Turkey) to improve access to long-term Islamic financing for SMEs and Export Oriented Enterprises (EOEs). The credit line is guaranteed by the Turkish government. This line of credit is an example of how conventional financing provided by an IDO can be channeled to meet the demand for financing according to Islamic law.

Participation banks represent a G20 success story in terms of asset-based and equity-based financing for SMEs. Participation banks are based on interest-free banking through supporting real economic activities via the utilization of profit and loss sharing principles. Even though they were not established as Islamic financial instutitons, Participation banks have been promoting the core values of Islamic finance and to be considered operating according to Islamic law they have to comply with the rules and guidelines defined by the respective *Shariah* governing bodies.

The Turkish participation banking industry has witnessed remarakable growth over the last decade but still accounts for only 5.5% of the Turkish banking system assets. The importance of providing this line of credit for Islamic banks stems from the fact that long-term financing represents a major obstacle for Islamic banks in Turkey, since most of their depositors prefer short-term saving instruments. At the same time, Islamic banks in Turkey need to be extensively supported since they attract proportionally more SMEs as they have almost double the SME loan portfolio to total loan portfolio compared to conventional banks in Turkey (as of March 2014, SME loans in Participation Banks accounted for 46% of their total portfolio compared to 25% in conventional banks).



From an Islamic finance perspective, the expected Subsidiary Financing Agreement (SFA) structure is a *Wakala* arrangement – an agency contract under which the participation bank finances the enterprise on behalf of TSKB. The participation bank acts as an agent for TSKB, investing on its behalf and offering a guarantee (a *Kafala* agreement) to pay back TSKB in case the enterprise fails to repay its obligations. Sub-financing to SMEs and EOEs is expected to be mostly *Murabaha* or *Ijara* and can be extended to other instruments compliant with Islamic law.

[24] Source: Compiled IBRD Project Appraisal Document, Report No. 86307-TR, June 2014

In 2014, the European Bank for Reconstruction and Development (EBRD) and the Islamic Corporation for the Development of the Private Sector (ICD) announced the launch of an SME fund targeting SMEs in the southern and eastern Mediterranean region (SEMED). The fund will mainly provide financing through equity-based financing instruments and is complemented with technical assistance to the implementing financial institutions and investee companies[25].

IDOs are not only a vital source of financial assistance in the form of loans or equity and asset-based financing intended for financial intermediearies and their intended SME beneficiaries in EMDCs, but also contribute strongly to these countries via the provision of technical assistance and grants to catalyze and support the development of an enabling environment through regulatury support and capacity building of human resources and financial markets stakeholders as well as through the enhancement of systems and processes supporting the development and implementation of Islamic financial products.

A remarakable initiative from IDOs has been by the World Bank through the establishment of the Global Islamic Finance Development Center (GIFDC) in Istanbul (*see Box 2.3*) a focal point in the World Bank focusing on the creation of a knowledge hub and platform to support the promotion of Islamic finance around the globe.

Box 2.3: Global Islamic Finance Development Center (GIFDC)

The World Bank's Global Islamic Finance Development Center (GIFDC) has been established in October 2013 in Istanbul with the support of the Government of Turkey.

As a Knowledge Hub for the development of Islamic finance globally, the center

- Provides technical assistance and advisory services to strengthen the institutional foundations of Islamic finance, including legal, regulatory, supervisory standards;
- Conducts Research on the linkages between Islamic finance and economic development, focusing on the potential contribution of Islamic finance to eliminating extreme poverty and boosting shared prosperity in Bank client countries.

The GIFDC Islamic Finance program components include:

- Research Programs
- Flagship Report Publication
- Islamic Finance Seminar Series
- Community of Practice
- Islamic Finance Inclusion Program
- Leaning Center
- Global Islamic Finance Development Center

Backed by the World Bank, the GIFDC is able to utilize is convening power and to act as a major faciliating hub for Islamic finance through its' network of global partners from development organizations, the public sector, standard setting bodies as well as private-sector pioneers in Islamic banking and finance.

Technial assistance and knowledge development throough IDOs. Some IDOs, such as the Islamic Research and Training Institute is a core Islamic economic and financial knowledge provider supporting also capacity building for SMEs around the globe. Another IDO contributor to the domain is the **Deutsche Gesellschaft fuer Internationale Zussamenarbeit (GIZ),** focusing

[25] Source: EBRD (2014)

solely on technical assistance and providing **substantial capacity building and research in the area of financial inclusion through Islamic finance**.

The Islamic Corporation for the Development of the Private Sector (ICD) is a core IDO providing an array of services to overcome the challenges of SMEs specifically in OIC countries. These services include the provision of advisory services, technical assistance, sponsoring and establishing investment vehicles (Islamic funds) targeting SMEs and establishing Islamic banks and Islamic leasing companies targeting SMEs.

Irrespective of the fact that SME financing in general is underserved especially in Emerging Markets and Developing Countries (EMDC), the gap specifically between the supply side of Islamic financing compared to the demand side or preference for Islamic financing is still significantly high and has to be further addressed by IDOs to ensure that cultural and religious preferences are taken into consideration to achieve univeral financial access. One of the core obstacles to achieve that aim is the scarcity in human resources with adequate expertise in Islamic finance from a practical perspective. Therefore technical assistance, especially for microfinance insitutions and NGOs who do not have a governing *Shariah* board, is essential. Similarly, most Islamic banks still rely heavily on *Murabaha* instead of diversifying their portfolio through other Islamic financial products, which is mostly due to the lack of risk management systems, processes and understanding of the other products.

2.3 Credit Guarantee Institutions

Small and Medium Enterprises are generally underserved by financial institutions due to the perceived high risk of SMEs as compared to government lending or lending to large corporations because of their lack of sufficient collaterals.

These challenges are partially overcome through the existence of strong Credit Guarantee institutions providing the necessary guarantees and thus facilitating the financing of SMEs and exports through banking and non-banking financial service providers.

A number of Islamic Credit Guarantee offerings have evolved to overcome the key challenges faced by SMEs to access financing. Examples include the Jordan Loan Guarantee Company, which provides an Islamic credit guarantee (*Kafala*) product for SMEs. Similarly, there is the Malaysian Credit Guarantee Corporation Malaysia Berhad and the *Kafala* Program backed by the Saudi Industrial Development Fund that provide credit guarantee programs for financing products according to Islamic law offered through participating banks to enhance access to finance to underserved SMEs.

In the case of Islamic finance, credit guarantees are a debatable arena due to different *Shariah* perceptions of its eligibility, especially in terms of paying a fee for the guarantee (Bin Badri, 2014). For instance, the Islamic Fiqh Academy of the Organization of Islamic Cooperation consider imposing a fee for a guarantee as impermissible whereas some contemporary *Shariah* scholars and organizations like the *Shariah* Advisory Council of the Central Bank of Malaysia consider charging fees for guarantees permissible.

Table 2.1: Product Export Statistics from G20 to OIC Countries in 2014[26]

G20 Countries	Product Exports to OIC Countries in USD millions	Total Product Exports from Origin in USD millions	% of Product Exports to OIC Countries to Total Exports
India	96,455	317,545	30.38%
Turkey	47,739	157,715	30.27%
Argentina	11,300	68,335	16.54%
Russia	68,204	492,145	13.86%
Indonesia	23,836	176,292	13.52%
China	295,595	2,342,808	12.62%
Republic of Korea	69,610	573,091	12.15%
Italy	63,224	528,368	11.97%
South Africa	10,693	90,612	11.80%
Saudi Arabia	39,687	348,905	11.37%
Brazil	25,003	225,098	11.11%
Japan	74,862	683,846	10.95%
France	59,100	566,656	10.43%
Australia	22,573	240,445	9.39%
United Kingdom	42,465	511,283	8.31%
United States of America	121,335	1,622,657	7.48%
Germany	97,832	1,508,346	6.49%
EU - Excluding G20 Members from EU	178,292	3,020,189	5.90%
Canada	11,408	472,866	2.41%
Mexico	4,119	397,506	1.04%
Total	**1,363,332**	**14,344,708**	**9.50%**

Provision of Islamic Credit Gurantees in the context of international trade with Islamic markets is crucial. Clear and significant representatives of EMDCs are OIC countries for instance. There are strong and significant trade relations between the G20 and OIC countries (*see Table 2.1*), since about 9.5% of the exports in 2014 of G20 countries are directed to OIC countries whose imports rely by about 75.2% on goods originating from G20 countries. In terms of export volume to OIC, exports within G20 are led by the EU (excluding G20 EU members), followed by China and the United States. In terms of the contribution to overall exports of the member country to the OIC, this is led by India (30.4%), Turkey (30.3%) and Argentina (16.54%). SMEs within that context are a major contributor to these trade relations since SMEs contribute significantly to

[26] Source: Compiled data from ITC – International Trade Statistics

the total exports value of their respective countries as it is the case for instance in Turkey (60%[27]), the European Union (34%[28]) and the United States of America (33%[29]).

The increase in the number of SMEs in the G20 member countries exporting to OIC country markets in which governments, borrowers and the financial institutions (such as Islamic banks) involved in the transactions growingly seek their import financing to be compliant with Islamic law is a natural evolvement and a strong opportunity. This can be clearly achieved by adapting to trade finance requirements of OIC markets through establishing export credit guarantee programs in compliance with Islamic law to be utilized for these markets and their *Shariah*-sensitive segment of importers.

The Hermes Cover (the Export Credit Guarantees for the Federal Republic of Germany), has a special emphasize on SME exporters (75% of applications for Hermes Cover are SMEs) due to the fact that these exporters would be much more impacted to absorb possible defaults and losses from their counterparts and their country risks compared to larger corporations[30]. A few Export Credit Agencies such as Euler Hermes, UK Export Finance and Export Development Canada have been engaged or are currently in the process of guaranteeing large-scale export transactions with counterparts from Islamic oriented EMDCs which should be further extended and supported to serve the exporting SME segment in their respective countries.

Even though debatable from different *Shariah* perspectives, the rise of Islamic partial credit guarantee schemes would surely encourage Islamic banks to provide increased financing to SMEs compared to the current status.

Scalability of SME financing through utilizing credit guarantees depends on Shariah scholars. Reaching Shariah consensus regarding the Shariah-compliance of credit guarantee schemes through further research and development and using existing models approved by Shariah board for instance in Malaysia, Saudi Arabia and Jordan is crucial and can lead to enhancing SME financing by Islamic banks significantly.

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[27] European Commission, Enterprise and Industry SBA Fact Sheet 2013 – Turkey , SMEs in Turkey are defined as companies with less than 250 employees

[28] In Cernat, Normal-Lopez and T-Figueras (2014), SMEs are defined as companies with less than 250 employees

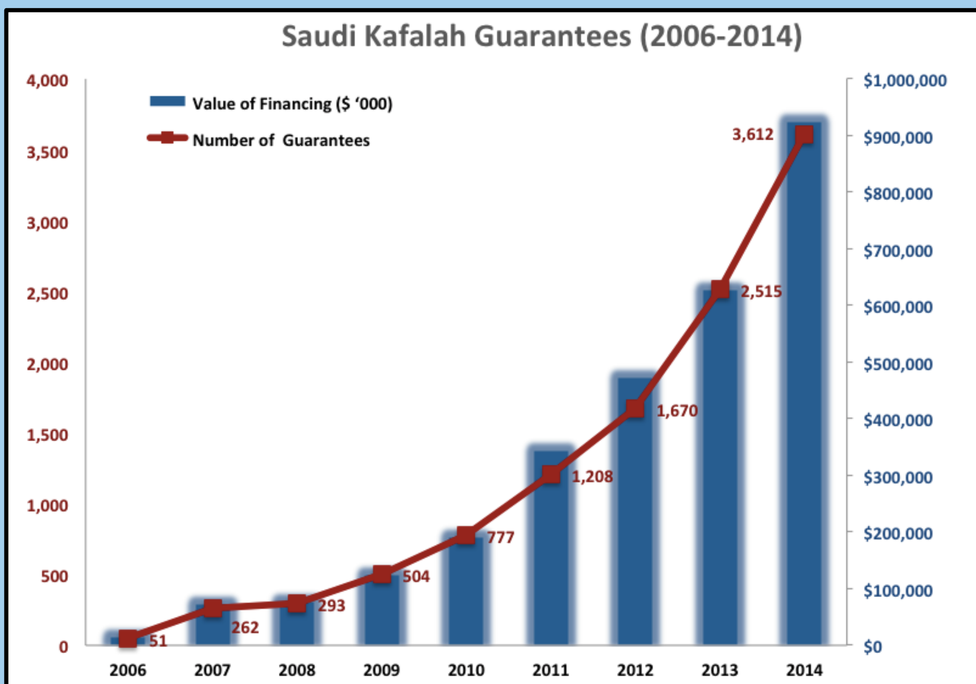
[29] US Department of Commerce, U.S. Export Fact Sheet – March 2014, SMEs are defined as companies with less than 500 employees

[30] Source: Hermes Cover website: http://www.agaportal.de/en/aga/grundzuege/mittelstand.html

Box 2.4: Saudi Industrial Development Fund *Kafala* - SMEs Financing Guarantee Program[31]

The Saudi Ministry of Finance and the Saudi Industrial Development Fund (SIDF), in cooperation with the participating financial institutions, established the *Kafala* SME Financing Guarantee Program in 2006 to improve financing to SMEs through covering up to 80% of the lender's risk in the event of full or partial default. The program aimed and succeeded in encouraging local commercial banks to finance SMEs, which are potentially viable but unable to provide the guarantees or accounting records required to prove their merit for finance.

The Program guarantees all types of credit facilities for SMEs, which are in compliance with Islamic law according to the *Shariah* guidelines of the respective financial institutions. Accordingly, the Program attracted some of the largest Islamic banks such as Al-Rajhi Bank, Al-Bilad Bank and Al-Inmaa Bank as well as conventional banks to use the *Kafala* Program for the range of Islamic financial products offered by them to SMEs.



According to the Oxford Business Group in their report *"Saudi Arabia 2014"*, the *Kafala* loan guarantee program proves to be a vital channel between banks and SMEs in a country where almost 90% of Saudi businesses are categorized as SMEs and only 3% of total lending serves these SMEs.

According to the statistics of the *Kafala* program in 2014, default rates of financing guaranteed through the program amounted to about 1% but on the other hand only about 48.7% of the value of financing is guaranteed, which means that the upside potential of increasing financing to SMEs and reducing the collateral requirements from Saudi banks has not been fully utilized since the *Kafala* program mandate indicates covering up to 80% of the financing amount.

31 Sources: Saudi Industrial Development Fund website http://www.sidf.gov.sa/En/Kafalah/Pages/Introduction.aspx

2.4 Leasing Companies

Leasing, an asset-based financial instrument for procurement of equipment, is an appropriate financing instrument for SMEs ,especially in EMDCs where the lack of collaterals, previous financial information and credit history hinders the financing of SMEs. With leasing, the ability of the SME to generate cash flows serving the lease payments is the main criteria of eligibility of financing as well as offering the financed asset as security for financing.

According to the IFC (2009), leasing is highly beneficial for startups and SMEs, especially as the lack of collateral requirements is advantageous in countries lacking business environments protecting creditors' rights and having no collateral laws and registries. Through leasing this is resolved due to the fact that the lessor owns the asset and thus repossession can be conducted if the lessee defaults on his payments.

Islamic leasing, *Ijara*, in principle is comparable to a conventional lease with minor differences such as in the ownerhship responsibilities, the type of assets permissible to be leased and to not reflect any interest-related characteristics in the contractual agreements (Johnson, 2005).

The variation between a conventional lease and an *Ijara* with respect to ownership responsibilities are more significant in an *Ijara* contract as the lessor is held responsible for the payment of periodic maintenance, asset insurance, taxes and/or any other costs that are directly related to the ownership title, while in a conventional leasing contract the lessor passes all these obligations to the lessee. Late payments by the lessee cannot be penalized under an *Ijara* contract from an Islamic law perspective and thus the lessor can only request early payments for future dues as a compensation for late payments or giveaway penalties for charity. With respect to the ownership title of the asset at the culmination of the contract, an *Ijara* contract should have a clear clause regarding the whether the lessee will buy the asset or not at the end of the lease, while in a conventional lease this is an optional clause (IFC, 2009).

According to the Islamic Corporation for the Development of the Private Sector (ICD, 2013) the main challenges to overcome to advance Islamic leasing include:

- **Lack of Regulations** for the leasing sector and especially Islamic leasing
- **Limited Availability of Funds,** especially medium and long-term funding
- **Scarce Human Resources** due to the shortage of leasing professionals and experts
- **Outdated Technology** supporting Islamic leasing processes
- **Lack of Islamic Insurance** to guarantee leased assets
- **Limited Exit Opportunities** due to underdeveloped debt market and stock exchanges

One of the initatives to overcome these challenges is pioneered by ICD, through establishing the *Ijara* Management Company in 2010, which provides advisory services with the mission to set up *Ijara* companies across all OIC countries.

Leasing provided outside of banks through bank-owned leasing companies or non-banked owned leasing companies are typically funded through local and international financial institutions and capital markets. In the context of Islamic finance, *Ijara* being an asset-based financial instrument compliant with Islamic law directly linked to the real economy, a growth in the number of leasing providers and volume to serve SMEs can be achieved through attracting *Shariah*-sensitive or targeted capital from Islamic financial institutions and capital markets.

Recommendations and opportunities for developing the leasing industry to serve SMEs especially in EMDCs are summarized by Al-Sugheyer and Sultanov (2010) with respect to the MENA region as follows:

- Leasing industry in MENA faces many impediments but could have a great impact since it can complement or replace bank financing for SMEs that lack sufficient collaterals and credit history due to its asset-backed nature which makes it easy to structure in accordance to Islamic law.
- More attention should be paid to strengthen the legislative framework governing leasing through specialized leasing laws including a clear definition and balance of rights and responsibilities of lease parties.
- Strengthening process for registering leased assets through the development of unified collateral registries
- Improvement of repossession procedures
- Tax rules need to be clear and neutral for lease transactions
- Development of insolvency laws clarifying rights of lessors and lessees under bankruptcy
- Long-term funding essential for long-term development of the leasing industry

2.5 Capital Markets

Capital markets globally represent an optimal venue for Islamic finance to grow and flourish. Capital markets adhering to Islamic law can be categorized mainly into securitized asset-based security markets and equity-based stock markets.

Islamic finance principles due to its asset-based nature support securitization through which ownership transfer is conducted via the issuance of Islamic securities such as Sukuk as opposed to conventional bonds. Sukuk holders receive returns based on the profitability of the asset utilized to finance the respective Sukuk. Based on a recent report conducted to assess the potential to mobilize institutional investors for SME financing in emerging markets, *Table 2.2* builds on that incorporating the potential of Islamic finance mainly through *Sukuk* issuances in mobilizing theses resources[32]. As indicated Shariah-compliant bond issuances by SME lenders as a refinancing mechanism, private placements as well as SME covered bonds can be considered as highly potential vehicles from an Islamic finance perspective contributing to the development of SME financing.

[32] World Bank, IMF, OECD (2015)

Table 2.2: Potential to Mobilize Institutional Investors for SMEs through Islamic Finance

INSTRUMENT	DESCRIPTION	POTENTIAL FOR ISLAMIC FINANCE
BOND ISSUANCES BY BANKS	- The issuance of bonds by either public or private offerings	*Moderate*
BOND ISSUANCES BY OTHER SME LENDERS	- It includes corporate bond issuances by SME lenders as a refinancing mechanism	*High*
BOND ISSUED BY SMES VIA ALTERNATIVE MARKETS	- Alternative markets for debt, that provides SMEs access to the public (retail) markets, under a proportionate framework that makes it easier for them to comply with disclosure requirements	*Moderate*
BOND ISSUED BY SMES VIA PRIVATE PLACEMENT	- Use of private offerings and tailor-made regimes of private offers for SME bonds, mainly addressed to institutional investors.	*High*
SME BOND FUNDS	- Collective Investment Schemes that pool together bonds issued by SMEs, usually structured as closed-end funds	*Moderate*
SME FUNDS BASED ON RECEIVABLES AND FACTORING	- The funds that invests in factoring companies. The fund typically purchases these receivables from SMEs, providing them with immediate financing at an implied interest rate that is lower to comparable bank rates.	*Low*
SME COVERED BONDS	- Debt securities by a credit institution those are backed by a pool of high quality assets	*High*
SME LOAN SECURITIZATIONS	- Securitization of SME loans (transformation of illiquid instruments to liquid tradable securities)	*Moderate*
SME LOAN FUNDS	- Collective investment schemes that pool together SME related assets (for ex: loans and receivables) and offer returns of to the investors of the fund.	*Low*

The issuance of asset-based securities in Capital Markets is a strong alternative to overcome the challenges faced by banks to provide financing to SMEs. In the case of Islamic banks for instance through the utilization of securitization on their existing SME financing portfolios, they are able to boost their financial capacity and extend additional financing services to their SME clients.

Capital markets are a clear alternative for SMEs to seek asset-based and equity-based financing outside the banking sector. Even though there have been international efforts to develop specific market places or exchanges supporting SMEs to get listed or raise asset-based financing, these efforts are still not proportional to the relevance of SMEs in terms of job creation and their contribution to economic growth. Therefore SMEs willing to raise asset-based or equity-based financing through the general capital markets accessible to both large corporations and SMEs, which might result in a disadvantage for SMEs due to the strict listing requirements imposed reducing the chance of SMEs to access these markets.

SMEs through public listing have access to growth capital and can thus increase their position for subsequent debt financing (OECD, 2015). SME exchanges are also an important venue encouraging early-stage financing from Angel Investors and Venture Capital funds providing potential exit opportunties especially in markets lacking exit opportunties such as across most EMDCs. One of the most developed global SME markets is AIM (Alternative Investment Market), the London Stock Exchange's international market for growing small businesses. Generally, listing requirements on such markets are less restrictive compared to main markets by not enforcing a minimum market capitalization and setting no minimum prescribed number of shares to be with public investors.

Other equity capital markets focusing on SMEs and startups include NEEQ-China, TSX Venture Exchange in Canada, the ACE market in Malaysia as well as the Emerging Companies Market (ECM) in Turkey. According to Borsa Istanbul (2015), ECM market capitalization reached US$ 343 million in May 2015, with 22 companies listed on the exchange with a trading value of US$ 890 million in 2014. ECM is characterized with relatively relaxed admission requirements for SMEs and growth companies compared to the main market.

One of the main challenges faced by SME stock exchanges according to OECD (2015) include the lack of equity culture, especially within family businesses that are not willing to relinquish ownership or control over the business. Another challenge is the lack of liquidity evidenced in such markets (such as Nilex SME Stock Exchange in Egypt) due to the low volume of traded shares and the limited free float because of the retained stakes of the intial owners, for instance. Some of the recommendations to resolve that within the OECD policy paper include providing these markets with capital to support ongoing liquidity and sales / equity research.

Stock markets are a perfect match for investments fulfilling the requirements of Islamic law due to their equity nature based on profit-and-loss sharing. Even though equity investments are an asset class compliant with Islamic law, investing in specific equities according to Islamic law is not a straightforward exercise since it is highly complex and needs to be handled with great precaution to ensure that the compliance requirements are met as intended by the *Shariah* governing body (the *Shariah* Supervisory Board). These *Shariah* governing bodies define a set of rules or guidelines, in the form of a set of rules or guidelines called a *Shariah* mandate to be followed, in order to determine which investments are to be considered eligible. One of the most common *Shariah* screening guidelines used globally is the one defined by AAOIFI (*see Box 2.5*).

Box 2.5: AAOIFI *Shariah* Screening Criteria for Compliant Equities[33]

Business Activity Screening
The core business of the company has to be in compliance with *Shariah* and thus the non-permissible income from the following sources should not exceed 5% of the total income of the company issuing the shares:
Adult Entertainment and Pornography, Alcohol, Conventional Banking, Defense, Entertainment such as Music or Cinema, Gambling and Casinos, Hotels serving alcohol and night-clubs, Insurance, Interest Income (Operating or Non-operating), Pork and Tobacco and any other activity deemed non-compliant by the respective *Shariah* Board

Financial Screening

- The interest-bearing debt divided by the 12-month trailing average market capitalization of the company does NOT exceed 30%;
- The total amount of interest-bearing deposits/investments divided by the 12-month trailing average market capitalization of the company do NOT exceed 30%;
- Liquiud assets divided by the 12-month trailing average market capitalization of the company do NOT exceed 70%.
- Preference shares are considered non-compliant

***Shariah* guidelines of AAOIFI or similar ones are utilized by different stock exchanges, fund managers, index providers and brokers to identify which equities are permissible to invest in from an Islamic law perspective**. From a business screening perspective, parallels can be found between Islamic law requirements and the guidelines used by Social Responsible Investing (SRI) and Ethical funds. The financial screens are intended to limit the extent of involvement of companies in conventional financial transactions since in global markets it is unlikely or rare to identify listed companies, which do not at least have bank accounts or investments generating interest. Multiple research from Derigs and Marzban (2008, 2009), Marzban and Donia (2010) and Asutay and Marzban (2012) have empirically identified that asset universes compliant with Islamic law are able to perform likely or even outperform their conventional counterparts.

As can also be noted in *Table 2.3* based on the actual performance of a conventional and Islamic small cap index in the United States, the Islamic index over a one year, five-year and ten-year time period outperformed the conventional index both in terms of returns but also in terms of risk-adjusted returns as calculated using Sharpe, Treynor and Jensen Alpha. Even though the Islamic index constituents are only a subset of the conventional parent index for the small cap companies included, due to the quality of stocks remaining in the Islamic index a higher risk-adjusted return can be noted.

As indicated by Asutay and Marzban (2015), the percentage of equities compliant with Islamic law ranges globally from 25% to 50% with highest compliance levels in the GCC (about 50%). This is a logical circumstance stemming from the fact that one of the main *Shariah* guidelines measures and limits interest-bearing debt to total market capitalization and thus markets

[33] Source: Summarized from AAOIFI Standard No. 21, 2010

where asset-based financing through Islamic banks or Sukuk issuances from the corporations is accessible and utilized, the likelihood of compliance is higher.

Table 2.3: Risk and Return of U.S. Conventional versus Islamic Small-Cap Indexes[34]

Period	Index	Actual Period Return	Mean Annualized Return	Beta	Sharpe	Treynor	Jensen Alpha
From Jul 2014 to Jul 2015 (1 Year)	DJ U.S. Small Cap Index	4.00%	9.88%	1.32	54.36%	6.37%	0.11%
	DJ Islamic Market U.S. Small-Cap Index	6.30%	13.44%	1.52	70.84%	7.88%	2.43%
From Jul 2010 to Jul 2015 (5 Years)	DJ U.S. Small Cap Index	113.07%	16.56%	1.25	83.44%	12.12%	-1.71%
	DJ Islamic Market U.S. Small-Cap Index	123.50%	17.84%	1.25	86.68%	13.07%	-0.53%
From Jul 2005 to Jul 2015 (10 Years)	DJ U.S. Small Cap Index	109.25%	10.53%	1.23	39.81%	7.37%	2.16%
	DJ Islamic Market U.S. Small-Cap Index	146.57%	12.28%	1.19	47.99%	9.11%	4.15%

From a G20 perspective, equity investments in compliance with Islamic law are expected to further grow in the future representing an opportunity for increased liquidity in their respective stock exchanges. From an investor perspective, according to Booz & Co (2011) *"a third of GCC clients prefer Islamic products over conventional products, depending on ethnicity and investment style"* and therefore already large investment fund managers in G20 countries such

[34] Calculations are based on annualized data calculated from monthly index prices for the given time periods using Dow Jones (DJ) U.S. indexes. The S&P500 index values for the same time periods have been used as market benchmark to calculate Beta and Excess Returns. The Risk Free Rate used is based on the average US 3-month T-bills from 2005 to 2014.

as in the U.S., U.K., Germany, Japan and South Africa are providing Islamic fund and discretionary portfolio services to institutional and individual investors mainly from the GCC.

On the other hand, the role of SME exchanges focusing on high-growth potential startups such as ECM and ACE within EMDCs countries have a much wider impact than just providing access to finance to these SMEs but could also result in a much more diversified equity market across EMDCs, especially for Islamic funds.

Table 2.4: Dow Jones Islamic Indexes Europe, U.S. and MENA Sector Allocation[35]

Sector	Dow Jones Islamic Market Europe Index	Dow Jones Islamic Market U.S. Index	Dow Jones Islamic Market MENA Index
Technology	7.28%	27.54%	0.03%
Health Care	26.59%	19.06%	0.85%
Oil & Gas	6.29%	10.83%	0.83%
Industrials	15.80%	12.57%	15.54%
Consumer Services	6.56%	11.60%	0.87%
Consumer Goods	21.55%	11.86%	4.22%
Basic Materials	13.09%	3.52%	3.99%
Financials	0.36%	2.97%	60.02%
Utilities	0.10%	0.04%	-
Telecommunications	2.38%	-	13.66%
Price Return % 3-Year Annualized	9.57%	14.19%	6.39%

***Table 2.4* reflects this issue through comparing the universes sector exposure in accordance to Islamic law of the MENA region to the Europe and U.S. market. The MENA market is mainly highly concentrated in the financial sector (60.02%) followed by the indutrial and telecommunication sectors**[36]. As can be noted in the above table, the MENA market has almost no exposure to technology and health sectors, whereas these two sectors represent almost 47% of the asset allocation of the Dow Jones Islamic Market U.S. Index and contributed positively to the overall return of the index.

This lack of diversification existing in Islamic markets represented here by MENA signals the relevance of SME stock exchanges and other equity-based financing mechanisms like Venture Capital funds to provide a pipeline of innovative, high-growth startups across different sectors.

2.6 Venture Capital and Private Equity Funds

Innovative and growth-oriented startups are significant contributors to job creation in G20 countries and especially in the U.S. where roughly 500,000 new ventures generate about three million jobs on an annual basis (infoDev, 2012). Similarly, in EMDCs, support for innovative

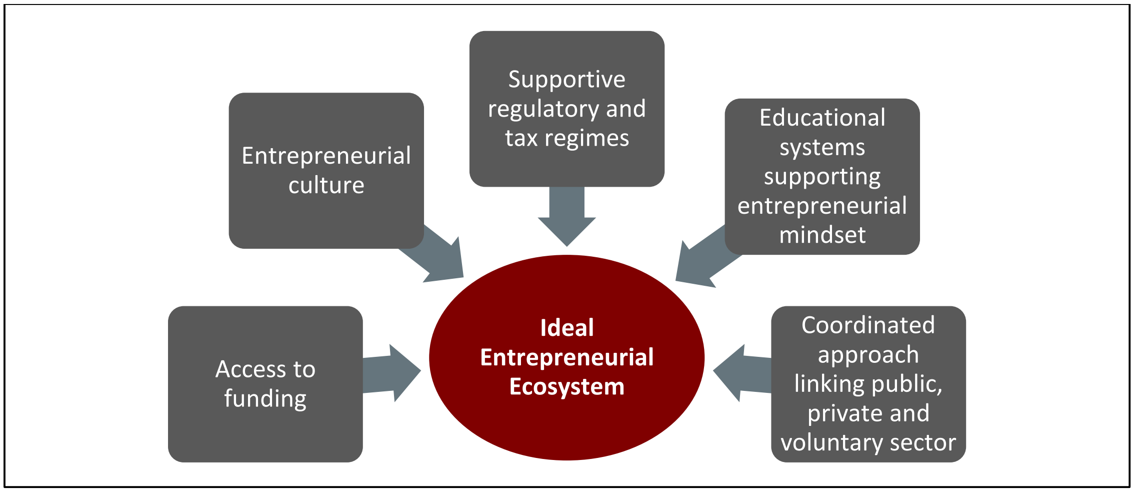
[35] Source: Dow Jones Fact Sheets, Data as of June 30, 2015 based on USD

[36] The Dow Jones Islamic Market MENA index does not include Saudi Arabia, which would have increased a bias towards Basic Materials sector as well

startups, especially in their early-stage to reach growth potential, is essential for economic growth and job creation. Nevertheless, the entrepreneurial ecosystem in most EMDCs has not yet developed enough compared to ecosystems in Silicon Valley or in G20 countries such as Germany and India.

An ideal entrepreneurial ecosystem (*Figure 2.2*) fostering the growth of entrepreneurial ventures has five main pillars according to Ernst & Young (2015):

Figure 2.2: Ideal Entrepreneurial Ecosystem Pillars



Venture Capital investments in India, for instance, grew from US$600 million in 2006 to US$1.4 billion in 2012 driven mainly by supportive regulatory changes through the elimination of taxes on capital gains and facilitation of foreign investments (Ernst & Young, 2015).

Venture Capital (VC) and Private Equity (PE) funds mainly provide early-stage and growth-stage startups with access to funding, which are a significant component of the entrepreneurial ecosystem and thus VC/PE funds act as catalyst for the growth of innovative, high growth startups and SMEs. According to Research by Ritter (2012), 35% of IPOs and 57% of technology startups IPOs in the United States from 1980 to 2011 were backed by venture capital funding, indicating the relevance of such financing for early-stage and growth startups. If we extend the success of these startups to include also Mergers and Acquisitions, then VC-backed Mergers and Acquisitions globally according to Ernst & Young (2014) from 2007 to 2013, for instance, have been six times larger than the number of VC-backed IPOs.

Since Islamic Finance primarily advocates profit-and-loss sharing principles in financial transactions, Venture Capital and Private Equity investments are a natural fit for both equity-based investments compliant with Islamic law as well as the provision of financing to startups and SMEs. Islam advocates real economic activities and the employment of capital to create social and economic welfare. Therefore, from an Islamic finance perspective, the profit-and-loss sharing *Mudaraba* and *Musharaka* models are considered best choices to structure VC and PE deals taking into consideration global VC/PE practices as well as ensuring compliance with Islamic law.

Requirements in terms of *Shariah* screening (portfolio companies to operate in and generate revenue from *Shariah-compliant* practices), financial leverage constraints and required purification processes for VC/PE funds and their portfolio companies intended to benefit from potential Islamic investors as defined for public equities (*see Box 3.5*) need to also consider the following common practices of conventional VC/PE funds (Marzban, 2012 ;2015):

- **Issue of Preference Shares**
  Private Equity and Venture Capital funds generally utilize preference shares rather than common shares to protect investors against expropriation and to finance the multiple stages or "rounds" of financing for their portfolio companies. VC/PE funds generally utilize convertible preferred shares or even participation preferred shares which provide their investors with a liquidation preference.
  From a *Shariah* perspective, preference shares are considered ineligible as defined within the AAOIFI Standard Number 21, Article 2/6 that *"it is not permitted to issue preference shares that have special financial features leading to the granting of priority to these shares at the time of liquidation or the distribution of profits. It is permitted to grant certain shares features related to procedural or administration matters, in addition to the rights attached to ordinary shares, like voting rights"*.

  Also based on the Islamic Fiqh Council of the OIC in 1992*, "… it is not permissible to issue preference shares with financial characteristics that involve guaranteed payment of the capital or of a certain amount of profit or ensure precedence over other shares at the time of liquidation or distribution of dividends. It is however, permissible to give certain shares such characteristics as are related to the procedural or administrative matters"*.

  Another characteristic attached to preference shares - especially within the context of Private Equity funds - is the existence of a cumulative compounded hurdle return as even though it is not a guaranteed return it would conflict with the AAOIFI standard of providing a preference at the distribution of profits.

  To overcome the *Shariah* issue of preference shares and to be able to protect investors' rights on a fair basis simultaneously, innovative financial structures based on combining interest-free loans (*Qard*) with *Musharaka* can be utilized or this target structure can be achieved through a *Mudaraba*, which according to AAOIFI also prioritizes capital repayment before profit distribution (Marzban and Asutay, 2015).

- **Leveraged VC/PE Transactions and Bridge Financing**
  Using debt to leverage VC/PE transactions is a norm in the industry, where the average debt to equity ratio for the majority of international PE funds is less than 40% according to PWC (2014). Since this debt is generally interest-based, from an Islamic perspective access to asset-based financing is essential to support the rise of the Islamic VC/PE industry or to attract a wider spectrum of Islamic capital providers to VC/PE funds. The same problem exists with bridge financing, since in PE funds, investors commit to provide capital for the fund over the investment horizon once a capital call is made by the General Partner (GP) rather than investing the full capital at initiation. Thus, a timing mismatch might occur between receiving the capital

and making an investment in advance. Bridge financing would be needed to conduct the investment and to pay the loan back once investors provide the committed capital. Therefore, the time factor, the global nature of PE acquisitions in different markets, and the lack of rapid and accessible bridge financing in compliance with Islamic law (such as through *Salam*) also has to be resolved.

Additionally, to support the evolution of PE/VC funds focusing on SMEs, which typically need capital to grow a potential equity-based investment model that is aligned with the long-term objective of SMEs owners especially in the case of family businesses, for instance, is to enter into a *Diminishing Musharaka* agreement that entitles the entrepreneur to buy back the shares of the asset or the company over time based on actual valuations.

In Figure 2.3, a proposed Islamic Private Equity and Venture Capital structure is shown (Marzban, 2015), which is able to overcome the core challenges required by Islamic law. In the proposed structure, the General Partner through their executive team contributes to the investment pool (about 1% of capital) to invest alongside the Limited Partners[37] (LPs) based on the same terms to align the interests between the different stakeholders. In the proposed structure, the capital of the fund is provided in the form of *Musharaka* capital.

Since the GP is responsible for the management of the partnership between the different stakeholders, and to make the capital calls, reporting, and cash distributions of the fund, the GP acts through a Restricted *Mudaraba* agreement as *Mudarib* on behalf of the LPs (*Rab-ul-Mal*), whereas profits are distributed based on predefined ratios – as per industry standards - to the GP (20% of profits) and the remaing 80% are distributed among the LPs.

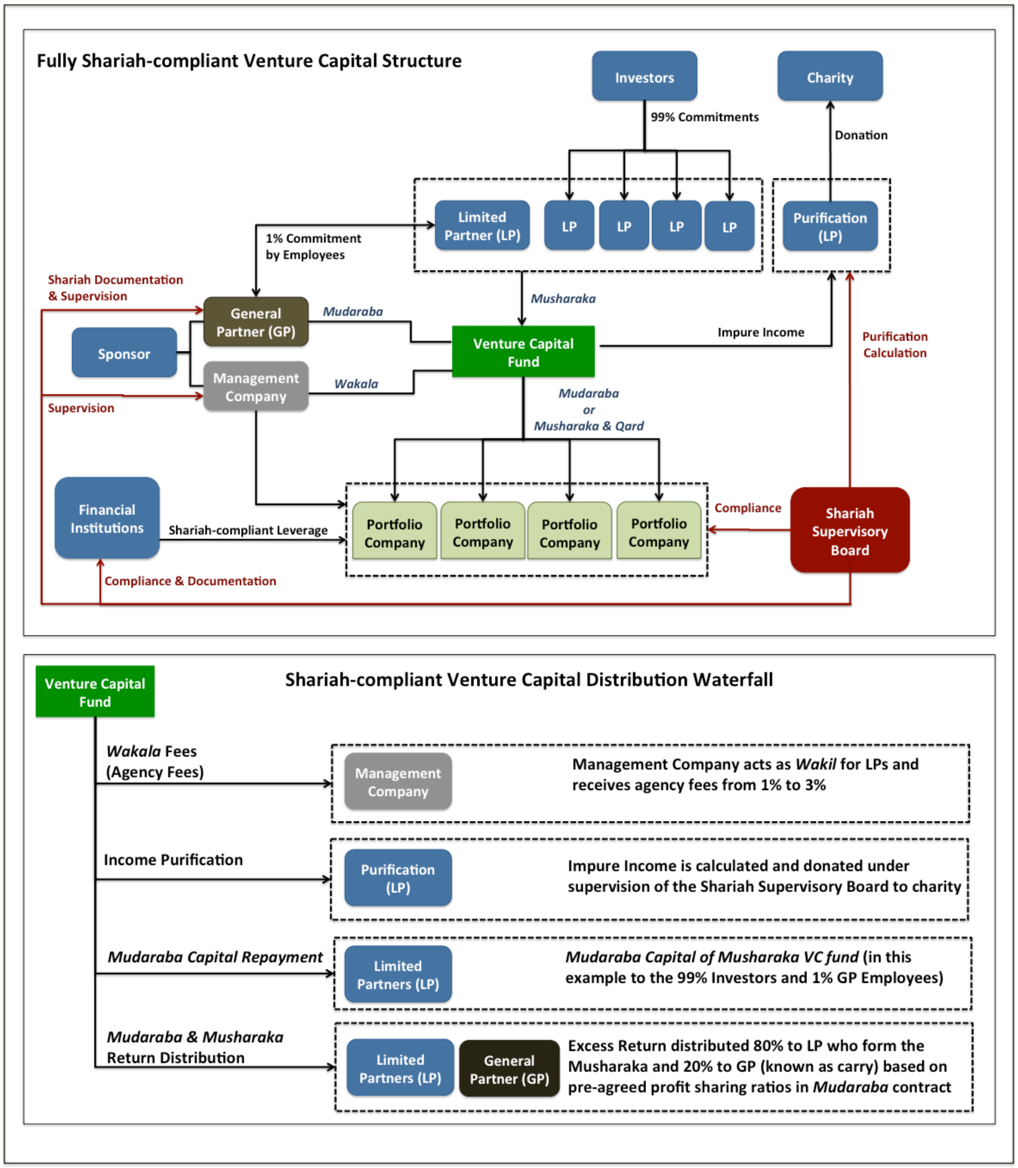
A *Mudaraba* contract solves the issue of liquidation preference by ensuring that the principal is repaid first before any profit distributions are conducted as is common practice in the PE/VC industry and as indicated in AAOIFI Standard No. 13, Article 8/7 *"no profit can be recognized or claimed unless the capital of the Mudaraba is maintained intact. Whenever a Mudaraba operation incurs losses, such losses stand to be compensated by the profits of future operations of the Mudaraba [....] All in all, the distribution of profit depends on the final result of the operations at the time of liquidation of the Mudaraba contract. If losses are greater than profits at the time of liquidation, the balance (net loss) must de deducted from the capital [....] If the total Mudaraba expenses are equal to the total Mudaraba revenues, the capital provider will receive his capital back without either profit or loss, and there will be no profit in which the Mudarib is entitled to share. If profit is realised, it must be distributed between the parties as per the agreement."*.

The Management Company is affiliated to choose the portfolio companies to invest in and to manage these investments on behalf of the Venture Capital fund based on a *Wakala* contract through which they receive agency / management fees.

[37] Limited Partners are mainly institutional investors such as pension funds, government agencies, fund of funds and endowment funds

In the case of the portfolio companies to be invested in, the capital of the fund is either provided through a *Mudaraba* similarily to the approach described above or through jointly utilizing an interest-free *Qard* with *Musharaka* capital in the respective deal.

Figure 2.3: A Proposed *Shariah-compliant* PE/VC Structure and Distribution Waterfall[38]



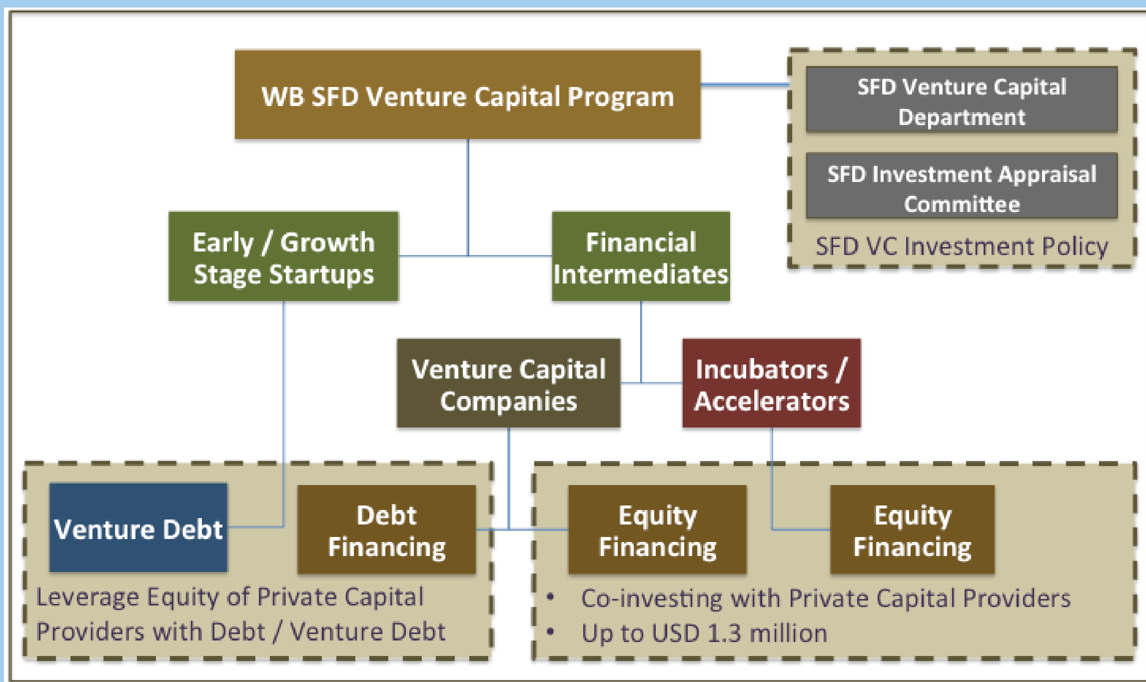
The implications of evolving Islamic VC/PE transactions are not only limited to foster entrepreneurship in EMDC countries, but would also substantially benefit mature markets such as in the G20 countries where entrepreneurial ecosystems can benefit from the access of finance provided from Islamic capital providers aiming for excessive return opportunities.

[38] Source: Marzban (2015)

Box 2.6: World Bank Social Fund for Development Venture Capital Program in Egypt

The World Bank (WB) in cooperation with the Social Fund for Development (SFD) launched the first government-driven Venture Capital Program (VCP)[39] in Egypt seeded with $15 million to act as catalyst for private sector co-investment (matching) in seed and early-stage startups through financing financial intermediates (Venture Capital companies or Incubators) in the form of equity or debt, or through financing startups directly with venture debt.

The program is part of the *"Promoting Innovation for Inclusive Financial Access Project"* of the World Bank and has been supported through a technical assistance grant supporting the establishment of a Venture Capital Department and an Investment Appraisal Committee, the development of an investment policy, providing VC documentation as well as providing professional Venture Capital training based on best global venture capital practices conducted by the World Bank VC team and the UC Berkeley.



The VCP is designed in a manner supporting both conventional funding sources as well as Islamic funding sources and targets investments to ensure that different development organizations' requirements as well as end-beneficiaries' needs are met.

For VC/PE funds residing in G20 countries with the objective to invest based on their conventional investment practices, structuring their offerings to fully satisfy Islamic law requirements might not be feasible, especially if the majority of their Limited Partners are conventional investors who do not want to be bound by Islamic law limitations on potential investment opportunities and instruments. A solution to overcome existing structures and still attract Islamic capital is through the structuring of parallel PE/VC investment vehicles where Islamic Limited Partners' capital commitments and contributions are pooled into an Islamic vehicle with a co-investment agreement between the three involved parties (GP, conventional fund

39 Source: Nasr, Marzban, Farid, Badr and Abdelkader (2015)

and the Islamic fund) that is entered with an opt-out option for the Islamic LP from specific deals considered not adhering to the Islamic law guidelines imposed on the fund.

Especially in markets where the venture capital industry is still not matured enough as compared to the U.S. or Europe, for instance, the government has to support the evolvement of a strong ecosystem not only by increasing access to funding but also through supporting regulation, education and acting as a facilitator. An excellent success story is India, where the Indian government has strongly supported the venture capital industry, for example through the state-owned SIDBI Venture Capital Limited which co-finances state-level funds and co-invests it with private Venture Capital funds (**Ernst & Young**, 2013). These efforts resulted in that SIDBI Venture now manages three Venture Capital funds and one Social Alternative Investment fund with an aggregate value of US$ 281 million and were able to exit about 70% of their investments (SIDBI, 2013).

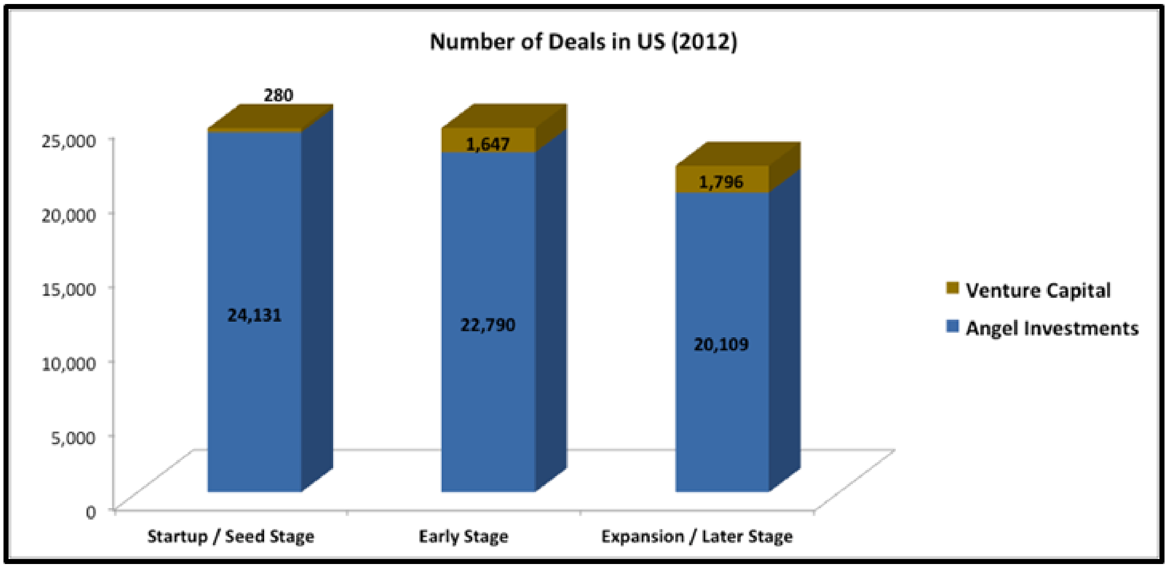
2.7 Angel Investors and Crowdfunding

Angel investors are a core element of a successful entrepreneurial ecosystem since they and their networks are core providers to capital to startups in their seed and early-stage compared to Venture Capital funds that enter in later development stages.

As can be shown in *Figure 2.4*, Angel investments in the U.S. nearly funded all deals in the initial development stages of the respective startups, indicating their relevance to the entrepreneurship market and their importance as a source of finance in the early stages for startups as a source of financing.

The significance of Angel networks is not only witnessed in the U.S. but can also be found across other G20 countries such as in India, Canada and the EU (Ernst & Young, 2015). In most EMDCs, Angel networks are still in their embryonic phase and have, according to infoDev (2012), not yet developed since there are limited in number and *"typically driven by individuals, and incubators with links to the Silicon Valley or to wealthy diaspora networks of investors"*. The role of International Development Organizations in increasing the access to finance for startups in EMDCs can be highlighted through the efforts conducted by infoDev, for instance, which assisted in creating angel networks in countries such as Jordan, Chile, Belarus, Moldova, Trinidad, Senegal, South Africa and Nigeria.

Figure 2.4: Number of Venture Capital versus Angel Investor Deals in the U.S. (2012)[40]



Currently, the financing of high-growth potential startups and small enterprises has to rely on alternative sources of funding based on innovative financial services that increase the pool of available funding and benefits from the technological developments to serve the needs of uprising entrepreneurs globally.

Over the last years, innovative financial services gaining more and more importance in the financing arena and evolving strongly are crowdfunding platforms, which utilize the Internet and social media to raise financial resources from a large network of people to support initiatives, projects or specific startups proposed by their respective founders on these platforms. So crowdfunding, similarly to angel networks, relies on a large number of individual investors, which in the case of crowdfunding could be referred to as micro-angels. The use of online crowdfunding platforms and online angel networks (such as Angel List) greatly facilitates linking potential initiatives with a much wider spectrum of potential local and global investors or backers, thus overcoming main challenges faced by entrepreneurs who are not able to raise funding sources from conventional financial service providers due to their location, perceived risk, lack of credit history or size of their venture.

Crowdfunding in the form of either rewards, debt (especially if it is in the form of asset-based financing), or equity compensation provides a new venue to increase financial inclusion through investment inclusion of new funding channels from retail investors that are given the opportunity to back real economic activities through potential projects or start-ups, which previously have been accessible only to institutional investors (venture capitalists) or angel investors.

[40] Source: Jeffrey E. Sohl, Center for Venture Research and 2013 NVCA Yearbook

Box 2.7: Types of Crowdfunding

There are different types of crowdfunding platforms, which can be categorized as follows:

1. **Donation-based crowdfunding**
   Typically backers support an initiative through donations from a purely philanthropic perspective without any expected future compensation.
2. **Reward-based crowdfunding**
   Within reward-based crowdfunding, backers receive an appreciation for supporting an initiative such as receiving a gift, acknowledgement for support, or being provided with the products or services developed. Reward-based crowdfunding is an excellent online venue to pre-selling products and using these proceeds for producing the goods or services offered.
3. **Lending-based crowdfunding**
   While the first two types are more philanthropic in nature, lending-based crowdfunding is an investment vehicle through which crowd investors provide loans to startups or small enterprises to support their ventures in exchange for receiving returns in the form of interest payments.
4. **Equity-based crowdfunding**
   Similar to lending-based crowdfunding, crowd investors are supporting startups or small enterprises for a financial gain. Within an equity-based investment, the investors receive shares in the venture financed and are thus part of a profit-and-loss sharing agreement with the funded startup. This type of crowd investing has to a large extent parallels with the venture capital industry, which is also equity-based.

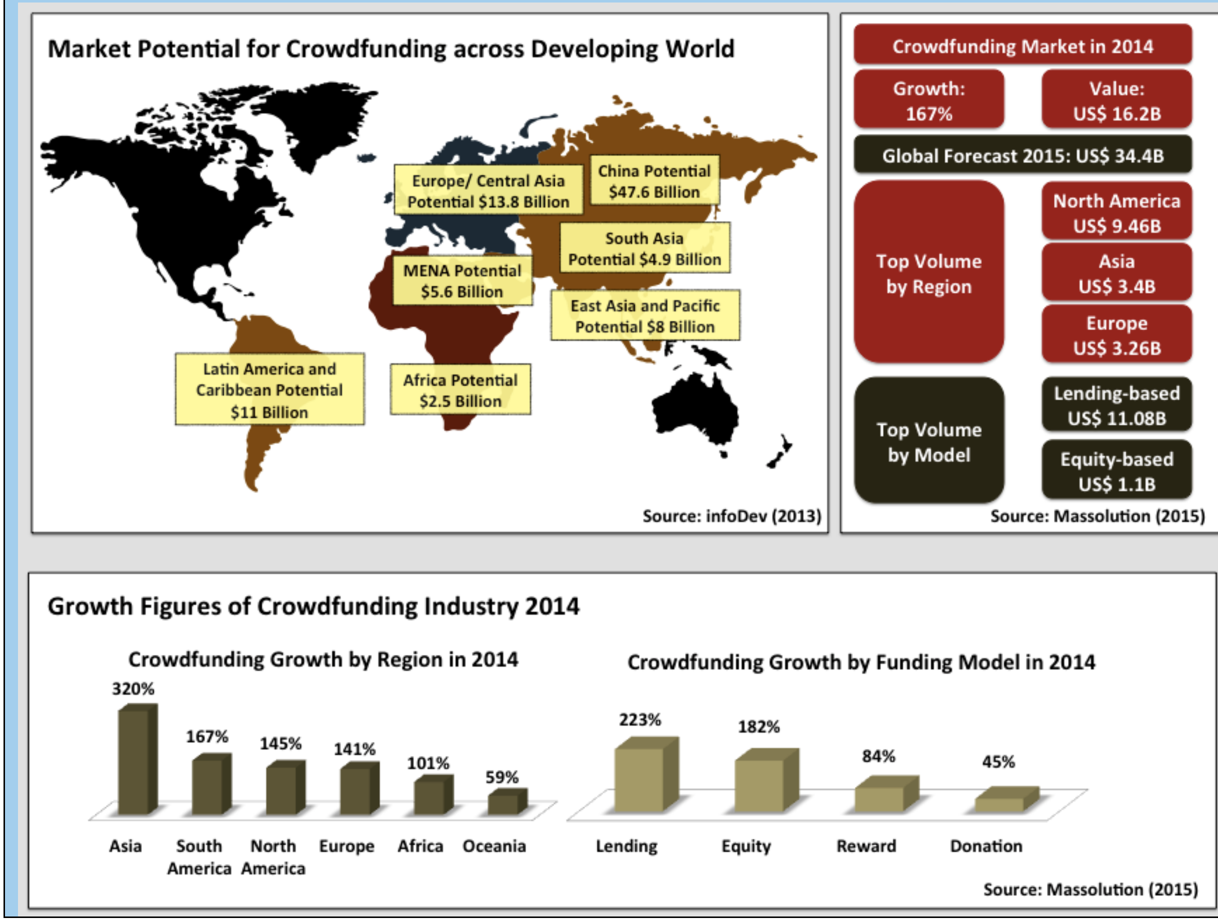
For startups and SMEs, mainly reward-based, lending-based and equity-based crowdfunding are relevant contributors to their access to finance.

The market size is significantly large (*see Box 2.8*) since according to Massolution (2015) the crowdfunding market grew by 167% in 2014, with a total of US$ 16.2 billion being raised across crowdfunding platforms globally. To comprehend the potential of crowdfunding according to estimates by the World Bank (2013,) if regulatory measures and enabling factors are achieved, the relatively young crowdfunding industry is expected to reach a market size in emerging countries totaling US$ 96 billion by 2025, which is almost twice the size of the veteran Venture Capital industry totaling US$ 48.5 billion around the globe in 2013. The bigger mass of potential investors attractable through crowdfunding is not only motivated by a future financial return, but by other factors such as being part of a success story, taking an active part in socioeconomic development or receiving some kind of reward.

These are all factors explaining the higher risk these investors are willing to take, especially since the amounts allocated per startup are relatively small, thus enabling them to diversify their risk across a portfolio of crowd-funded ventures (Collins and Pierrakis, 2012).

To increase the access to capital, especially in EMDCs where the entrepreneurial ecosystems are still under development, instead of relying on limited institutional capital only via venture capital funds or on high net worth individuals via angel investor networks, a greater capital pool can be provided through engaging a much larger base of small investors such as the increasing middle class around the globe as well as the global diaspora flowing for instance from G20 countries to OIC countries (total of US$ 92.4 billion in 2014 according to the World Bank) to fund SMEs and startups in their countries of origin. This process is referred to as financial inclusion via investment inclusion (Marzban, 2013), which can be most efficiently achieved via innovative financial services such as crowdfunding.

Box 2.8: Global Crowdfunding Industry



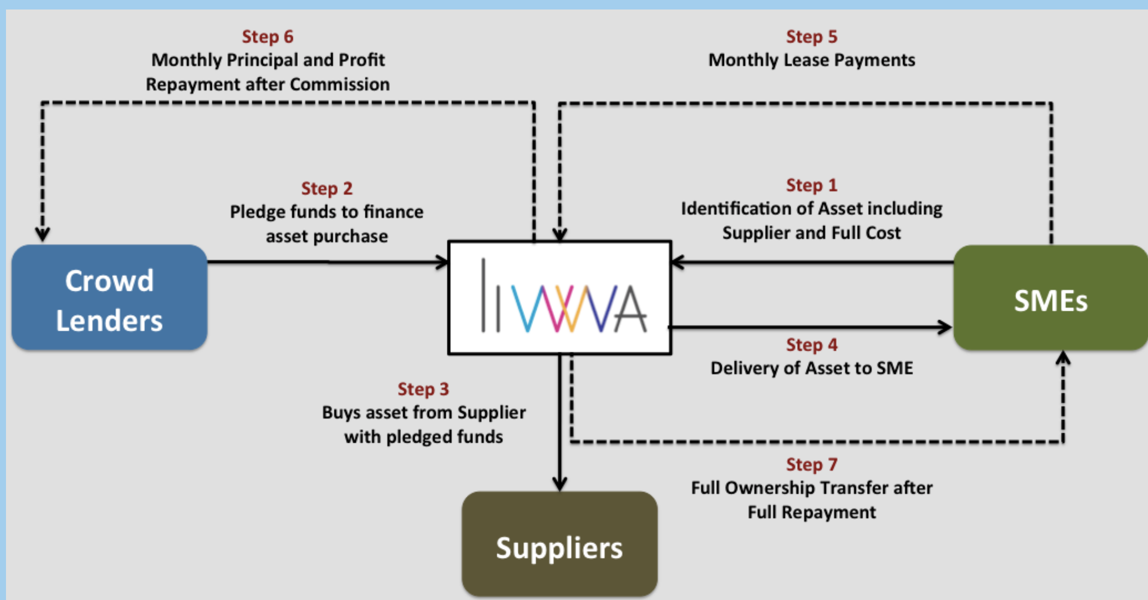
Islamic finance at its origin is a moral and value oriented approach aiming to utilize economic and financial resources to satisfy the material and social needs of all members of the community, and therefore crowdfunding represents a significant opportunity to utilize the different crowdfunding models in a manner compliant with Islamic law underpinning the core ethical and social dimensions of Islamic finance.

Crowd lending, which is mainly based on interest payments, is not compliant with Islamic law. Thus to provide asset-based crowdfunding, the respective platforms could rely on Islamic financial contracts and processes to provide interest-free alternatives such as the use of *Murabaha* of *Ijara*, for instance, which is currently being offered by the Jordanian-based Liwwa platform (*see Box 2.9*).

Box 2.9: Liwwa – Asset-based Crowdfunding Platform

Liwwa, a Jordan based electronic crowdfunding platform that has been launched in September 2013, support SMEs with working and physical capital needs through raising funds from a crowd of investors who pool in their capital in return of the principle amount invested and part of the profit in the form of monthly payments or installments. Working like a lease-to-own structure (*Ijara*), after full repayments the borrower becomes the whole owner of the assets acquired through the raised funds.

The financing provided to companies through Liwwa ranges from around US$14,000 to US$21,000 and until March 2015 they intermediated around 34 asset-based financing transactions attracting diverse Islamic and conventional investors.



One of the core challenges facing crowd lending platforms especially in EMDCs is the lack of regulation allowing others than banks or leasing companies to be licensed to provide asset-based financing to SMEs.

From the perspective of Islamic finance, equity-based crowdfunding represents a significant opportunity to deliver the essential expectations from Islamic finance by combining the benefits of social development and investment opportunities based on profit and loss sharing for a wide range of entrepreneurs and investors.

Based on Asutay and Marzban (2012), the advantages of equity-based crowdfunding from an Islamic finance perspective include:

- Equity-based crowdfunding is based on a profit and loss sharing basis (*Musharaka* or *Mudaraba*), as characterized in the original form of Islamic finance;
- Providing access to capital to a wide range of entrepreneurs thus reducing the funding gap;
- Opening up a new asset class for small and medium investors;
- Minimizing risk through splitting limited capital across multiple start-ups;

- Promoting innovation and keeping the talent local;
- Creation of jobs through the established start-ups;
- Supporting the growth of ventures to enterprises and possible future IPOs in new sectors such as the technology and health sector which are almost non-existing in the public equity markets in Muslim countries and thus increasing diversification for fund managers.

To ensure *Shariah*-compliance, Islamic equity-based crowdfunding has to ensure the following criteria:

- The platform has to be governed by a *Shariah* board or *Shariah* advisory
- Investments have to be socially responsible;
- Start-ups have to operate in *Shariah-compliant* businesses and thus not be generating income from non-*Shariah-compliant* sources;
- Due to the fact that the crowdfunding service provider (if compensated through equity) and the backed investors collectively represent a significant equity ownership in the start-up, clear legal restrictions have to be defined to ensure that the start-up does not raise interest-based debt, deposit cash, invests in non-compliant instruments, or extends the product and service portfolio to include non-compliant activities in the future;
- The typical shareholder structure enforced legally by venture capital firms in terms of granting preferential rights for the investors is deemed non-compliant. Therefore the shareholder structure and investor protection requirements have to be designed to adhere to *Shariah* principles as described in the previous venture capital section.

Table 2.5: *Shariah-compliant* Crowdfunding Models and Instruments[41]

Financing For	Crowd Model	Potential Beneficiary	Instrument With End Client
Product	Reward-based	Small Enterprises Startups	Sale
Investment	Asset-based	Small Enterprises	*Murabaha* *Ijara*
	Equity-based	Small Enterprises	*Diminishing Musharaka* *Musharaka* & *Qard* *Mudaraba*
		Startups	*Musharaka* & *Qard* *Mudaraba*

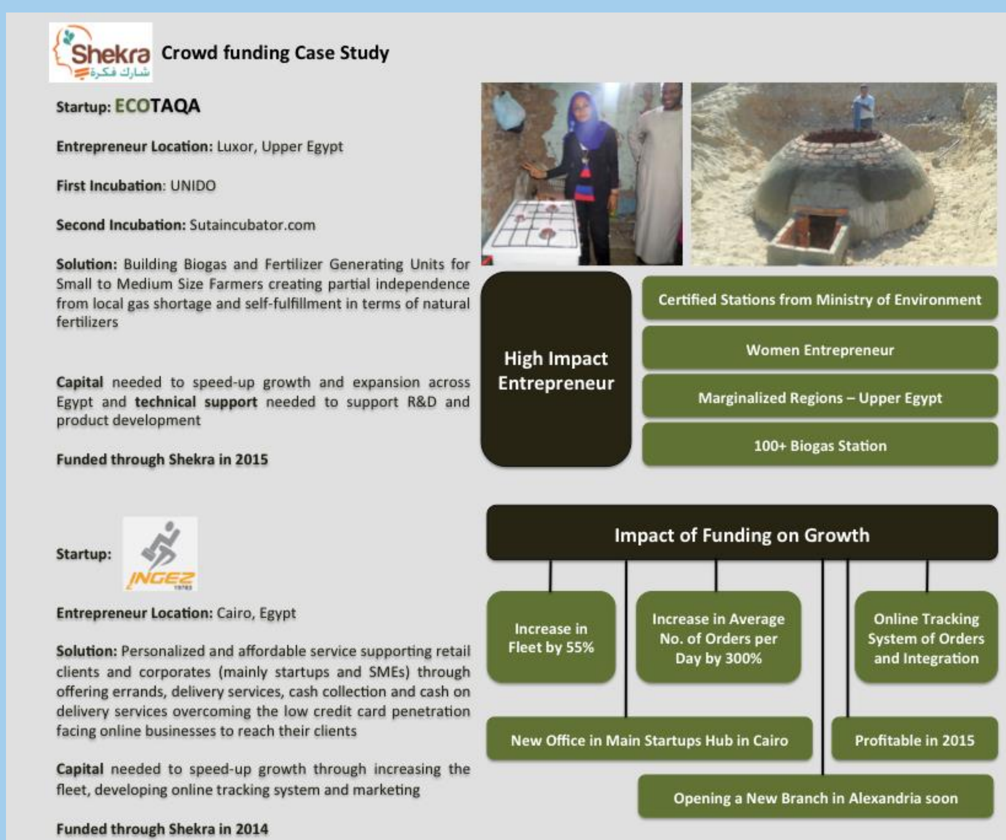
In *Table 2.5*, a number of proposed *Shariah-compliant* crowdfunding models are provided. To address the needs of different classes of entrepreneurs, a clear distinction between startups and small enterprises is crucial in order to provide financing mechanisms that reflect their long-term purposes and vision for the respective venture. Small enterprise owners such as restaurants, agricultural products or family businesses in general seek financing to grow their businesses rather than targeting a possible acquisition. For such financing purposes, the exit scenario is in the form of a share buyback by the respective entrepreneur through using a *Diminishing Musharaka* agreement between the entrepreneur and the crowd.

[41] Source: Marzban et al. (2014)

In the case of startups with growth potential, the typical venture capital equity nature is more appropriate to employ due to the increased risk nature of seed / early stage startups, which is compensated through expected multiple returns from a prospective exit scenario. Thus employing the same solutions proposed to *Shariah-compliant* Venture Capital funds for startups through *Mudaraba* or structured contracts based on both *Musharaka* and interest-free loans to ensure fair distribution among capital providers in the case of liquidation represent a best case scenario as applied by one of the *Shariah-compliant* equity crowdfunding platforms – Shekra Crowdfunding in MENA (*see Box 2.10*).

Box 2.10: Shekra – Equity-based Crowdfunding Platform

Shekra, an Egyptian equity-based crowdfunding platform that has been launched in November 2012, tackling the funding gap and startups that are too big for incubators, too small for venture capital funds and too risky for banks. Financing provided to startups through Shekra targets the range from US$ 20,000 to US$ 200,000. To serve the needs of both startups and SMEs through the Shekra platform companies can receive equity-based financing in the form of *Musharaka* and *Diminishing Musharaka*. Shekra has financed and support seven startups across different industries such us in the sustainable development sector, delivery and errands services, an online psychiatric support service as well as a renewable energy provider for farmers.



Even though the efforts of Shekra have been recognized through receiving the Islamic Economy Award for *"Best SME Development"* by Sheikh Mohammed Bin Rashid Al Maktoum in the UAE and *the "Ethical Finance Initiative Award"* by Thomson Reuters and Abu Dhabi Islamic Bank, the lack of regulation for crowdfunding, enforceability of shareholder agreements, digital payments and digital company formation represent core challenge limiting the growth of the initiative.

The main challenge to benefit from the significant potential of crowdfunding in EMDCs and especially OIC countries is not in terms of structuring the crowdfunding deals to be *Shariah-compliant* but to create an enabling environment supporting the utilization and flourishing of crowdfunding as an innovative and effective channel for access to finance.

Crowdfunding in the G20 countries is already highly contributing to facilitating financial access for startups and SMEs due to the financial infrastructure, internet and electronic payments penetration, the relative advancement in regulations in some countries as well as the entrepreneurial culture existing in most G20 countries compared to most EMDCs. Still, lack of regulation is one of the key factors hindering the growth of crowdfunding both in G20 countries as well as EMDCs, a challenge that needs to be tackled to unlock the potential of unleashing entrepreneurship as a key driver for economic growth around the globe.

The core driving factors for a crowdfunding enabling environment can be summarized as follows[42]:

- **Capital:** Access to capital from a potential crowd of investors to back the start-ups is a crucial component of the success of crowdfunding. The growth rate witnessed across the globe in the crowdfunding industry and the potential market size forecasted indicate that access to global capital is achievable if the other enabling environment factors are achieved.
    - **EMDCs** potential as a source of capital through crowdfunding is clearly remittances, which as an indication from only the G20 countries to OIC countries in 2014 totaled US$ 92.1 billion (World Bank Remittances Data, 2015). If a fraction of that amount is incentivized and facilitated to support crowdfunding campaigns or other SME developmental funds, significant socioeconomic developmental impact in terms of fostering entrepreneurship can be achieved.
    - **G20 countries,** especially the U.S. and Europe are showcasing strong access to capital through crowdfunding, reaching an aggregate of US$ 12.72 billion raised through crowdfunding platforms (Massolution, 2015).

- **Entrepreneurial Ecosystem,** in terms of cultural readiness and education for entrepreneurship development and support and the existence of ecosystem stakeholders and interest groups providing pre-funding and post-funding services creating a pool of potential start-ups and supporting follow-up funding and possible exits. This includes the existence of formal and informal education programs supporting entrepreneurship, government programs for entrepreneurship, incubators, accelerators, and co-working spaces, exchange programs with other global startups hubs, angel networks, Venture Capital and Private Equity funds as well as SME stock exchanges. International Development Organizations, governments in the G20 as well as the governments in EMDCs in partnership with the private sector have to support the establishment of new and the growth of existing entrepreneurship development initiatives to support innovation and potential economic growth.

[42] OECD (2015), infoDev (2013), Marzban (2015)

- **Infrastructure** is a key cornerstone to enable crowdfunding due to its nature of utilizing the Internet as it relies on: Internet penetration, social media penetration, digital payment penetration and the online processing of legal transactions.

    - **Internet and social media** are growing strongly in EMDCs, but are still lagging behind penetrations in G20 countries (for instance, Internet penetration in MENA is 48.1% compared to 76.5% in the EU and 86.9% in the U.S. according to Internet World Stats (2015)).

    - **Digital payments** are the key challenge in EMDCs countries due to the lack of diverse digital payment gateways that could reduce transaction costs of crowdfunding in addition to low credit card penetration and online bank transfers in these countries. Financial infrastructure enhancement is urgently needed to increase potential online investors and to reduce the overall cost of funding on crowdfunding platforms.

    - **Legal transactions online** to be made possible through digital signatures and other verification technologies would support strengthening the core value proposition of online crowdfunding, since in countries like Egypt or Malaysia, for instance, to establish a company, to register shareholder rights, and for the legal documentation, a number of offline activities has to be conducted by the crowdfunding investors such as providing a power of attorney among other legal documents.

- **Regulation** is core enabler of crowdfunding as indicated by OECD (2015), and can be summarized into the following elements:
    - Since crowdfunding is public fundraising it cannot be considered as a private placement and thus without specific regulation is considered a public offering governed by highly complex processes similar to IPOs. To overcome this, some platforms such as Shekra Crowdfunding, operate as a closed network of investors, which results in limited growth and not being able to utilize social media and other public marketing to increase outreach.
    - Investment-based crowdfunding such as equity crowdfunding offers shares to backers in the respective startup companies, which in most jurisdictions is legally limited to a maximum number of shareholders hindering the concept of crowdfunding to finance initiatives with small amounts from a large pool of investors.
    - Clear regulatory frameworks are needed to protect against fraud, the management of a large number of shareholders, and the disclosure of sensitive information to the public.

    - Other regulatory issues not specific to crowdfunding but relevant in general for startups are the enforceability of shareholder agreements, which are in most EMDCs not protected by local law resulting in the forced setup of the ventures offshore, increasing the overall transaction flow and hindering in some cases the potential flow from restricted domestic capital.

    - Regulation providing incentives for investing in startups such as tax incentives, as is the case in the UK (the Enterprise Investment Scheme), and the elimination of capital gain taxes in India have supported an increase of capital provided to startups and is thus recommended to be followed.

Similarly, according to Ernst & Young (2014) Turkey introduced tax incentives for accredited angel investors allowing them up to 100% tax deduction of their investments from their personal income taxes. The incentive resulted in more than 100 angel investors to register within the first year of implementation to benefit from the tax advantage.

2.8 Recommendations for Non-Bank SME Financing

The following table (*Table 2.6*) includes a summary of recommendations to be conducted by the policy makers, financial institutions and IDOs to improve access to asset-based and equity-based financing from non-banking financial service providers.

Table 2.6: Non-banking Financial Services Recommendations

SERVICE	RECOMMENDATIONS
CREDIT GUARANTEES	- International knowledge-transfer to EMDCs - Technical assistance from IDOs to Central banks and Credit Guarantee Companies - Increasing funding to serve larger base of SMEs - Law enforceability - Human resources development
LEASING	- Improved leasing laws - Increasing funding sources - Technical assistance especially in Islamic leasing - Human resources development
CAPITAL MARKETS	- *Sukuk* laws - Further standardization of Islamic law practices in finance - Incentives for SME Stock Exchanges
VENTURE CAPITAL	- Laws for SPVs - Technical assistance for Islamic VC structures - Reducing capital gain taxation - Enforceability of shareholder agreements - Increasing funding sources - Increase in government VC funds and programs - IDO co-investment funds - Domestic success stories - Increasing number of incubators and accelerators - International mentorship programs
ANGEL INVESTMENTS / CROWDFUNDING	- Tax incentives for angel and crowd investors - Digital payments and company structuring - Reduction of digital transaction costs - Crowdfunding regulation - Cross-border capital transfer - Technical assistance for crowdfunding platforms and entrepreneurship education in universities

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Annex – A

COMPARISON OF MODEL LAW AND SHARI'AH PRINCIPLES WITH RECONCILIATION SUGGESTIONS	
Liability exposures of the debtor, grantor and secured part in different situations are not discussed in this Table. All summary statements are subject to detailed conditions, restrictions, exceptions and the like referred to in the text of this report. Virtually all AAOIFI principles are subject to further explication and interpretation by the various schools of Islamic jurisprudence.	
Model Law Provision	***Shari'ah Principles***
General Matters	
***Reconciliation Suggestion**: Adopt Model Law (see AAOIFI Standard allowing registration as possession and receipt in certain scenarios) and conform to Model Law; this is the interpretative trend in Islamic finance and is consistent with existing Maliki interpretations.*	
• *Allows the contract parties to exclude various interests, transactions and categories from its scope.*	• *Shari'ah applies to all matters mandatorily; parties cannot choose to exclude matters.*
• *Excludes certain matters from its scope (e.g., intellectual property, assets subject to specialized registration regimes (automobile, aircraft, vessels, etc.), personal, family and household assets.*	• *Shari'ah applies to all matters mandatorily; parties cannot choose to exclude matters.*
• *Model Law governs and is superior as adopted, as secular law.*	• *Shari'ah principles of different schools in different jurisdictions; Shari'ah is overlay to secular law*
• *Applies to movable assets.*	• *Applies to all assets, movable and immovable, real and personal property; applicable only to non-fungible property.*
• *Security right created pursuant to a security agreement meeting requirements; debate about application of certain requirements to only possession situations.*	• *Rahn contract requirements similar to Model Law, but may require greater detail as to certain items (e.g., secured obligation (including each element of indebtedness), future advances (there are Shari'ah issues here), relationship of encumbered property to other property (occupying or occupied property), whether obligations is "matured" or "established", proceeds, some enforcement elements).*
• *Oral security agreements permissible where secured creditor has possession of encumbered asset.*	• *Oral contracts permissible in all instances.*
• *Security right bindingness determined by local law (often upon offer and acceptance); vary by jurisdiction and by whether common law or civil law.*	• *Rahn contract not binding in most jurisdictions until encumbered asset delivered to and **received** by secured creditor (before delivery and receipt, grantor can void rahn contract); exception is Maliki where binding upon offer and acceptance (and delivery can be compelled).*
	• *AAOIFI does not require physical delivery and receipt (possession by registration or, for debts, possession of debt documents).*

• *Grant of security right before establishment of secured obligation (debt) is valid.*	• *Grant of rahn prior to establishment of the secured obligation (debt) (a) is valid for Shafiʻis and Hanafis and under AAOIFI standard, and (b) is invalid for Malikis and most Hanbalis.*
• *Possession may remain in the debtor.*	• *Possession may not remain in debtor or grantor, with exceptions for some schools.*
• *Receipt is not a relevant concept; notice by registration and possession are of relevance.*	• *Receipt for immovables is physical possession or, for some schools, removal of impediments to possession.*
	• *Receipt of movables is complex, varies by school; all recognize possession by secured creditor; Hanafis also recognize removal of impediments to physical possession.*
Obligations That May be Secured	
***Reconciliation Suggestion**: Make no adjustments to Model Law in respect of acceptability of specific types of debt (including interest-bearing debt) or use of haram assets as encumbered assets; leave implementation to courts and enforcement entities applying the Shariʻah; except embody rules permitting enforcement where a non-Muslim is the secured creditor (Muslims will not enter into the rahn agreement involving impermissible debt or haram assets if that is contrary to their interpretation of the Shariʻah).*	
***Reconciliation Suggestion**: Reconcile by clarifying that a matured obligation is one that is known and binding and includes future advances under an agreement that establishes a maximum amount for the total obligation (debt) and is otherwise defined with sufficient specificity.*	
Clarify Shariʻah principles regarding intellectual property with relevant jurists and scholars; adopt reconciliations that are as close to the Model Law provisions as is consistent with the Shariʻah principles.	
• *Any obligation, present or future; determined or determinable; conditional or unconditional; fixed or floating; one or more obligations may be secured.*	• *One or more obligations may be secured.*
	• *Not permissible to secure an impermissible obligation if Muslim grantor and Muslim secured party.*
	• *Different opinions on whether an obligation that is partly non-compliant may be secured; some allow securing of principle on an interest bearing loan; some allow no valid rahn if any portion is not Shariʻah compliant.*
	• *Different opinions on whether a haram obligation owing by Muslim to non-Muslim secured party (impure encumbered asset has value to non-Muslim); many allow this as valid.*
	• *AAOIFI allows acceptable debt under Shariʻah, but not usurious loan or non-debt (usufruct of an object).*
	• *Obligation (debt) must be "matured" and "established"; complicated and differing interpretations; must be known and definitively established as a fully-binding liability; if debt probabilistic, it is invalid (thus, serious questions about whether future advances are valid debt for a rahn).*
	• *Hanafis, Malikis and AAOIFI allow rahn of a promised loan; Shafiʻis and Hanbalis do not allow rahn in respect of future debt, whether or not there is a promise (i.e., must be fully advanced).*
	• *Malikis require a "fungible" debt.*
	• *Addition of secured obligation to existing rahn is generally not permitted; exception for Malikis and some Hanafis.*
• *Security right in tangible asset with respect to which*	• *Shariʻah rules unclear, but rahn extends to all property of all types.*

<table>
<tr><td>intellectual property is used does not extend to intellectual property (and vice versa).</td><td></td></tr>
<tr><td colspan="2">Property That May Be Encumbered</td></tr>
<tr><td colspan="2">Reconciliation Suggestion: Do not make special adjustments to Model Law in respect of acceptability of specific types of debt (including interest-bearing debt) or use of haram assets as encumbered assets and leave implementation to courts and enforcement entities applying the Shariʻah; with the exception that the classically-accepted rules that will provide enforcement where a non-Muslim is the secured creditor (the rationale is that Muslims will not enter into the rahn agreement involving impermissible debt or haram assets as encumbered assets if that is contrary to their interpretation of the Shariʻah).</td></tr>
<tr><td colspan="2"></td></tr>
<tr><td>Any type of movable asset, including future assets, undivided rights in movable assets, generic categories of movables assets, all or part of a grantor’s movable assets; note special requirements for negotiable documents, tangible assets covered by negotiable documents, non-intermediated securities, negotiable instruments, rights to payment of funds credit to bank accounts, and receivables.</td><td>Shariʻah analysis is two-step: first fundamental elements of a property that is eligible to constitute marhun (an encumbered asset); and second separate rules applicable to each of future assets, portions of assets, undivided and unidentified interests in assets, portions of assets, assets occupied by other assets, assets occupying other assets, and specific types of assets.</td></tr>
<tr><td></td><td>To be eligible to constitute an encumbered asset, the property must be saleable (with interpretive variations by jurisprudential school):
exist at inception of rahn contract;
be deliverable at contract inception;
constitute “property” under the Shariʻah;
be valued;
be known and identifiable; broad categories impermissible to Hanafis, but allowed by Shafiʻis and Hanbalis;
be owned by grantor of rahn (with some exceptions, e.g., property of a third party with consent);
be unoccupied by a non-rahn property;
be separate and not connected to another non-rahn property;
be clearly identified as separate from other property; and
be received by the secured creditor.</td></tr>
<tr><td></td><td>Must satisfy conditions for a rahn:
valued property; the most difficult aspect is that usufruct is not property to Hanafis, Hanbalis and Shafiʻis (although Shafiʻis allow usufruct as encumbered assets if added after contract inception); AAOIFI allows usufruct (i.e., a security right may be established in some property to secure payments due in respect of usufruct);
known;
deliverable;
received by secured creditor;
possessed by secured creditor;
unoccupied by a property not subject to the rahn;
be separate from other properties;</td></tr>
</table>

	• *be distinguished from other properties.*
	• *AAOIFI allows valid rahn in, and as a valid encumbered asset, a share in common property (with requirements).*
	• *Hanafis rule that unidentified portion of a property may not constitute a valid encumbered asset, whether or not the property is divisible.*
	• *Hanbalis, Malikis and Shafi'is allow unidentified parts of properties as a valid encumbered asset, whether or not the property is divisible; Malikis require that it be all undivided interests of the grantor in the property; Hanbalis and Shafi'is require consent of the co-owners.*
	• *Rules for property connected to another non-rahn property are similar; AAOIFI does not separately address this.*
• *Special rules applicable to negotiable documents, tangible assets covered by negotiable documents, non-intermediated securities, negotiable instruments, rights to payment of funds credit to bank accounts, and receivables.*	• *AAOIFI standard permits as encumbered property debts, cash, current accounts, sukuk, financial papers and equity, and future income streams from these properties.*
	• *Under classical Shari'ah principles, these are not separately addressed, other than debts, cash and accounts (with special rules applicable to accounts).*
	• *Debtor may create rahn in asset owed to the debtor by the secured party.*
	• *Hanafis, Shafi'is and Hanbalis rule that a fungible liability to the debtor from third party is not valid as an encumbered asset (but Shafi'is and Hanbalis leave the rahn intact for future proceeds on the liability).*
	• *Malikis allow certain liabilities as encumbered assets with requirements (e.g., maturity of liability must be earlier than maturity of secured obligation).*
	• *All schools allow valid rahn on the grantor's owned property that is leased or loaned to another person and most allow on property deposited with another person, but each has conditions (e.g., a subsequent rahn may invalidate the lease or loan).*
	• *Grantor borrower of property may grant a rahn on the borrowed property; with owner consent' subject to owner constraints for Hanbalis; different rules where property is borrowed for the purpose of being used as collateral; and with different rules on the permissibility of use of the borrowed property; and with different rules as to ability of property owner to demand return of the property at any time (all but Malikis allow such a demand).*
	• *Permissible to grant a rahn on leased property, if acceptable to property owner.*
	• *AAOIFI allows rahn on borrowed or leased property with permission of property owner.*
	• *May not grant a rahn on the property of others without having a legal right (permission, etc.).*
• *Multiple security rights of differing ranks and priorities in encumbered assets are permissible, and payment of senior interests prior to junior interests is permissible.*	• *AAOIFI permits multiple security rights of differing ranks and priorities in an encumbered asset, and AAOIFI permits payment of senior interests prior to junior interests.*

	• *Shari'ah rules vary by whether a second security interest is taken in a portion or all of the originally encumbered property.*
	• *Hanbalis, Malikis and Shafi'is allow second security interests on unidentified portions, subject to some consent and other requirements; Hanafis do not permit security interests in unidentified portions of property, so the issues do not arise.*
	• *Hanafis, Hanbalis and Shafi'is do not permit second security right on previously encumbered assets, although if consent of the original secured party is given to a second security right, the first security right is voided (same result if secured creditor grants a security right with permission of the owner of the encumbered asset).*
	• *Malikis allow a second security interest in an encumbered asset of the value of the encumbered asset exceeds the amount of the originally secured obligation and with restrictions on the sale of the asset until the maturity date of the original secured obligation and divisions of the encumbered asset if the second secured obligation matures before the first secured obligation.*
	• *Special rules apply to security rights in indebted estates; AAOIFI provides that the heirs of the deceased are substituted for the deceased grantor.*
• *For the most part, perishables are not subject to separate rules; general principles applicable to safeguarding of the assets apply with factual adjustment.*	• *AAOIFI, Hanafis, Hanbalis and Malikis allow security rights in perishables, but impose unique rules on safeguarding of the perishables.*
• *No distinct rules on assets that transform into another asset or form.*	• *Shari'ah rules may apply if a permissible asset is transformed into an asset that is not permissible under the Shari'ah (e.g., fermentation of grapes into alcohol).*
• *Intangible property is not treated any differently than tangible property except to the extent that it may constitute a class of property that is specifically addressed in the Model Law (and note that intellectual property is not subject to the Model Law).*	• *There are uncertainties as to whether intangible property (especially intellectual property) is "property" for Shari'ah purposes; scholars differ in their interpretations.*
Proceeds, Accretions and Additions	
***Reconciliation Suggestion**: Modify Model Law to incorporate AAOIFI Standard, but expand definitions and concepts to include accretions, increases, additions, rent (specifically), and other proceeds from operation and functioning of the encumbered asset (except any proceeds from loss, damage or destruction, which are substituted for the encumbered asset).*	
• *Model Law extends to identifiable proceeds of an encumbered asset (whatever is received in respect of an encumbered asset, whether by sale, lease, dispositions, license, insurance, claims, compensation or civil and natural fruits (dividends,*	• *Concept of proceeds largely consistent with Model Law in enforcement scenarios, and the same regarding proceeds of sale, other disposition, loss, damage and destruction (proceeds are substituted for the original encumbered asset); but note Shari'ah preference for sale in remedies situations.*

<table>
<tr><td>distributions), and proceeds of proceeds; manner in which effectiveness is achieved varies; security rights continue in a commingling and “mass or product”, following the original pre-commingled asset.</td><td></td></tr>
<tr><td></td><td>Somewhat different rules in non-enforcement scenarios: different proceeds treated differently:
Proceeds derived from the operation and functioning of the encumbered asset (excluding, e.g., loss, damage and destruction), presumed to be property of the owner of encumbered asset; jurisprudential rules interpret “increases” and methods of creating the security rights quite differently and care must be taken..
Amounts from loss, damage and destruction of the encumbered asset are generally treated as a substitute for the encumbered asset that was lost, damaged or destroyed.
Accretions and increases of the encumbered asset are treated separately; interpretations differ considerably by what constitutes an increase (e.g., rent is not an increase subject to the original security right; voluntary additions are permissible, but there are procedural requirements).
Additions to the encumbered asset are treated separately (see below).</td></tr>
<tr><td></td><td>Integration (e.g., movable into an immovable) under Shari‘ah may change status and rules.</td></tr>
<tr><td></td><td>AAOIFI treats appreciation in value and income from encumbered asset as subject to security right on underlying encumbered asset.</td></tr>
<tr><td colspan="2" align="center">Effectiveness of Security Right Against Third Parties</td></tr>
<tr><td colspan="2">Reconciliation Suggestion: Modify Model Law to incorporate AAOIFI Standard (and see section in this table entitled “Proceeds, Accretions and Additions”). With respect to registration and possession, Model Law concepts need not be changed, but registrations should be adopted as a possession and receipt equivalent (see AAOIFI Standard) and possession should be harmonized definitionally and as to coverages.</td></tr>
<tr><td colspan="2"></td></tr>
<tr><td>Security right is effective against third parties if (a) notice in a registry or (b) secured creditor has possession; special rules for bank accounts, negotiable documents and non-intermediated securities; if security right is effective, then security right in proceeds of that encumbered asset is effective against third parties either without further action for certain assets or for a short</td><td>AAOIFI recognizes registration and possession, but classical interpretations will further inform these principles; all recognize possession; an increasing number of scholars recognize registration, but registration systems are largely absent in the relevant jurisdictions; all assets are treated the same under the Shari‘ah (for the most part)</td></tr>
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period pending necessary further action for other assets.	
• *Possession is "actual [physical] possession of a tangible asset, money, negotiable instruments, negotiable documents and certificated non-intermediated securities by a person or its representative, or by an independent person that acknowledges holding it for that person".*	• *Shari'ah concepts are, for the most part, based upon actual physical possession and the correlative (with detailed rules) includes receipt by the secured creditor.*
	• *Malikis recognize constructive possession concepts.*
	• *Possession concepts are complex: see debtor use summaries below*
Priority	
***Reconciliation Suggestion**: Modify Model Law to incorporate AAOIFI Standard and clarify that a second or subsequent security right does not invalidate any senior security right.*	
• *Priority over competing claimants is recognized and a significant aspect of the Model Law provisions; determined by order of third party effectiveness (see detailed rules) and follows into proceeds; with asset-specific rules for money, negotiable instruments, funds credited to bank accounts, tangible assets covered by negotiable documents, non-intermediated securities, and other categories.*	• *Priority is recognized in the holder of the security right as against other creditors; as noted in the summary of second secured rights, there are strict limitations on (and usually there is no acceptance of) secondary secured rights (only unsecured rights); priority extends into bankruptcy and insolvency; equal sharing of excess proceeds by unsecured creditors.*
	• *Recall Malikis allow certain second security rights (subject to excess value over the original secured obligation and maturity date determinations).*
	• *Recall AAOIFI permits multiple security rights of different ranks and priorities (with consent of same and higher priority security rights), with retention into bankruptcy and insolvency.*
Sales, Transfers, Leases and Licenses	
***Reconciliation Suggestion**: There will likely be enduring differences by jurisprudential school. Consult with Shari'ah scholars and jurists before determining how to reconcile the Model Law with relevant Shari'ah principles. The secured creditor consent provisions of the Model Law may be acceptable under all jurisprudential schools.*	
***Reconciliation Suggestion**: With respect to buyers, lessees and licensees in the ordinary course of business, clarify the relevant Shari'ah principles with Shari'ah scholars and jurists before determining how to reconcile the Model Law with relevant Shari'ah principles.*	

• *A buyer, transferee, lessee or licensee of an encumbered asset acquires its rights subject to a security right in that encumbered asset that is effective at the time of the sale, transfer, lease or license, with certain express exceptions. One such exception is where the secured creditor authorizes the sale or other transfer free of the security right.*	• *Hanafis, Hanbalis and Shafi'is: sale prior to delivery to and receipt by secured creditor is valid (contract not binding until delivery and receipt); purchaser is unburdened by a security right; there will be no asset in which to obtain a security right unless the purchaser agrees to provide a security right in that asset.*
	• *General rule: no sale by debtor without secured creditor consent (with variations).*
	• *Malikis: sale by a debtor after offer and acceptance of the rahn, but before delivery and receipt of the encumbered asset, where secured creditor is negligent in demanding delivery, is a valid sale unburdened by any security right and there is no security right for secured creditor.*
	• *Malikis: sale by a debtor after offer and acceptance, but before delivery to and receipt by secured creditor, where secured creditor is diligent in demanding delivery but deliver and receipt not consummated: three different positions:* • *allow sale unburdened by security right and substitute proceeds as encumbered asset;* • *allow sale unburdened by security right and substitution of proceeds if delivery to third party purchaser is consummated, but allow voiding of sale if delivery to third party purchaser is not consummated; and* • *allow sale unburdened by security right and do not substitute proceeds as encumbered asset (leaving creditor unsecured).*
	• *Malikis: sale with consent of debtor and creditor prior to delivery and receipt of the encumbered asset: sale is executed, the purchaser takes unburdened by the security right, and the proceeds of the sale are substituted as the encumbered asset.*
	• *Malikis: sale by debtor after delivery and receipt of encumbered asset by secured creditor: secured creditor may elect to (i) void the sale and continue the security right or (ii) permit the sale which voids the security right so that the purchaser takes unburdened by the security right.*
	• *Malikis: sale by secured creditor without debtor consent suspends the sale transaction:* • *sale is executed if debtor consents, and the purchaser is subject to security right, and security right is voided, and* • *sale is voided if debtor does not provide consent.*
	• *Shafi'is: general principle is that debtor is not permitted to sell encumbered asset to a person other than secured creditor without consent of secured creditor.*
	• *Shafi'is: sales by debtor valid if to secured creditor or with consent of secured creditor; the security right is voided; and the purchaser takes unburdened by the security right.*
	• *Shafi'is: sale by debtor without consent of secured creditor are invalid, and security right continues.*
	• *Shafi'is: sale by secured creditor with debtor consent invalidates the security right and purchaser is unencumbered by security right.*

	• *Hanbalis: sales by debtor without the consent of secured creditor are invalid.*
	• *Hanbalis: sales by debtor with the consent of secured creditor are valid and render the security right invalid and purchaser takes asset unburdened by the security right.*
	• *Hanbalis: sale by secured creditor without debtor consent are invalid, security right continues.*
	• *Hanbalis: sale by secured creditor with debtor consent invalidates the security right and purchaser is unburdened by the security right.*
	• *Hanafis: sale by debtor without permission of secured creditor is suspended:* • *sale becomes valid and executable if secured creditor permits the sale (sale proceeds are substituted as encumbered asset and purchaser takes unburdened by security right), if debtor repays the secured obligation, or if secured creditor absolves debtor of secured obligation (sale proceeds are substituted as encumbered asset and purchaser takes unburdened by security right), and* • *sale remains suspended if secured creditor does not give permission and there is no sale unless purchaser elects to wait until security right is removed, whereupon purchaser, if purchaser had no knowledge of the security right, has option to (1) wait and execute sale upon removal of security right (e.g., at payment of secured obligation) or (2) ask judge to void the sale.*
	• *Hanafis: sale by secured creditor without debtor consent suspends the sale transaction:* • *sale is executed if debtor consents (presumably the sale proceeds are substituted as the encumbered asset), and* • *sale is voided if debtor does not provide consent.*
• *The rights of a lessee or licensee of an encumbered asset are not affected by the security if the secured creditor authorizes the grantor to lease or license the asset unaffected by the security right.*	• *Malikis: lease or license by debtor after delivery and receipt of encumbered asset by secured creditor: secured creditor may elect to (i) void the sale and continue the security right or (ii) permit the sale and void the security right.*
•	• *Malikis: lease by secured creditor without debtor consent suspends the lease transaction:* • *lease is executed if debtor consents, and lessee is subject to security right, and (A) security right is voided if lease maturity date is after maturity date of secured obligation (such that the lessee is unburdened by the security right), and (B) security right is not voided, and continues in effect, if the lease maturity date is prior to maturity date of secured obligation and there is a lease requirement or market convention that the lessee return asset to secured creditor at the end of the lease term, and* • *lease is voided if debtor does not provide consent.*
	• *Shafi'is: debtor can lease encumbered asset if final maturity date of lease is prior to maturity date of secured obligation, and rights of lessee (and probably also a licensee) are not affected by the security right if secured creditor agrees; debtor cannot lease if final maturity date of lease is after maturity date of the secured obligation.*
	• *Shafi'is: lease by debtor with secured creditor consent, the security right remains in effect and lessee takes subject to the security right.*

	• *Shafi'is: lease by secured creditor without debtor consent are invalid, security right continues.*
	• *Shafi'is: lease by secured creditor with debtor consent does not invalidate the security right (it continues) and the lessee is burdened by the security right.*
	• *Hanbalis: lease by secured creditor without debtor consent are invalid, security right continues.*
	• *Hanbalis: lease by secured creditor with debtor consent does not invalidate the security right (it continues) and the lessee is burdened by the security right.*
	• *Hanafis: lease by debtor without permission of secured creditor is suspended:* • *lease becomes valid and executable if secured creditor permits the lease, whereupon the security right is invalidated, and lessee is unburdened by security right, and* • *(lease is probably voided if secured creditor does not give consent, but this is not yet confirmed).*
	• *Hanafis: lease by secured creditor without debtor consent: lease is executed and security right becomes invalid (the lessee thus takes unburdened by the security right); and (A) rent belongs to secured creditor if debtor did not approve of the lease, and (B) rent belongs to debtor if debtor approved the lease.*
• *The rights of a lessee of a tangible encumbered asset or a licensee of an intangible encumbered asset in the ordinary course of the lessor's or licensor's business are unaffected by the security right if the lessee or licensee, at the time of the conclusion of the lease or license agreement, does not have knowledge that the lease or license violates the rights of the secured creditor under the security agreement.*	• *No ordinary course of business exceptions.*
• *A buyer of a tangible encumbered asset sold in the ordinary course of the seller's business acquires its rights free of the security right if, at the time of conclusion of the sale agreement, such buyer does not have knowledge that the sale violates the rights of the secured creditor.*	• *No ordinary course of business exceptions. There are some "prior knowledge" considerations.*
	• *Hanafis: sale by debtor without permission of secured creditor is suspended:* • *sale becomes valid and executable if secured creditor permits the sale (sale proceeds are substituted as encumbered asset and purchaser takes unburdened by security right), if debtor repays the secured obligation, or if secured creditor absolves debtor of secured obligation (sale proceeds are substituted as encumbered asset and purchaser takes unburdened by security right), and*

	• *sale remains suspended if secured creditor does not give permission and there is no sale unless purchaser elects to wait until security right is removed, whereupon purchaser, if purchaser had no knowledge of the security right, has option to (1) wait and execute sale upon removal of security right (e.g., at payment of secured obligation) or (2) ask judge to void the sale.*
Preservation, Use, Sale and Lease of Encumbered Asset	
***Reconciliation Suggestion**: With respect to preservation of the asset and its value, adopt the Model Law possession concepts, and harmonize with AAOIFI Standard (note the debtor possession rules under the Shari'ah).*	
***Reconciliation Suggestion**: With respect to reimbursement of secured creditor for preservation expenses, adopt the Model Law as stated and clarify language to encompass Shari'ah concepts.*	
***Reconciliation Suggestion**: With respect to secured creditor use and debtor use of the encumbered asset, allow either debtor or secured creditor use with the permission of the other, with proceeds of use for the benefit of debtor (a slight variation of AAOIFI Standard as to compensation). There will be significant variations by jurisprudential school (and thus geographic location and the foregoing may not be acceptable to all schools).*	
• *The responsible party "must take reasonable steps to preserve the asset and its value. Open as to who is the responsible party, but turns on, primarily, who has possession of the encumbered asset.*	• *Secured creditor has obligation to safeguard the encumbered asset in the manner that it would safeguard its own property.*
	• *Possession of trust for Hanafis (liability for full value of asset only if transgression or usurpation); if violates, then possession*
	• *Possession of guarantee in all cases for Hanbalis, Malikis and Shafi'is.*
	• *AAOIFI: unless otherwise agreed, debtor bears all safekeeping, documentation and selling expenses.*
• *Secured creditor has right to be reimbursed for reasonable expenses for preservation of the asset.*	• *AAOIFI: debtor bears all expenses of decay, diminution and reparation of encumbered asset.*
	• *AAOIFI: unless otherwise agreed, debtor bears all safekeeping, documentation and selling expenses.*
	• *Classical (all schools): debtor is responsible for upkeep, preservation and use expenses.*
• *Secured creditor has right to make reasonable use of the asset.*	• *AAOIFI Standard: allows the debtor to benefit and use the encumbered asset during the term of the rahn with the permission of the secured creditor.*
	• *AAOIFI Standard: secured creditor has no right to use or benefit from the encumbered asset free of charge whether or not the debtor has given permission for such a creditor use; if the debtor does give permission for secured creditor use and benefit, the secured creditor must pay to the debtor the "normal pay" for similar assets.*
	• *Shafi'i: debtor use permitted, but debtor may not harm the encumbered asset; all benefits of use are for the debtor account.*
	• *Shafi'i: secured creditor use is impermissible.*
	• *Hanafi: debtor use only with permission of secured creditor; except if debtor can benefit from use without taking possession (e.g., a machine or land) then benefit of output belongs to debtor.*

	• *Hanafi: secured creditor generally not permitted to use; interpretive variations are (a) acceptable with debtor permission, (b) never permitted, and (c) permissible if specified in security agreement.*
	• *Hanbali: debtor use only with permission of secured creditor; except if debtor can benefit from use without taking possession (e.g., a machine or land) then benefit of output belongs to debtor.*
	• *Hanbali: secured creditor generally not permitted to use (other than specific rules for animals and certain loans).*
	• *Hanbali: if debtor and secured creditor cannot agree, property remains mandatorily unused.*
	• *Maliki: strictest: debtor prohibited from using asset in all circumstances; secured creditor permission for debtor use invalidates the security right*
	• *Maliki: secured creditor use permitted in only one situation involving a specific sale contract.*
• *Secured creditor has right to apply monetary proceeds of the asset to repayment of the secured obligation.*	• *Secured creditor has right to apply monetary proceeds of the asset to repayment of the secured obligation.*
Prepayment of Secured Obligation	
***Reconciliation Suggestion**: Local law determination; leave to contractual parties (if they desire Shari'ah compliance, they will adopt Shari'ah principle); adoption of Shari'ah principle may adversely affect capital markets instruments (other than pass-through instruments) because they are usually built on a no-prepayments financial model; could hold and invest prepayments and then pass them into the capital markets instrument as if no prepayment had occurred.*	
• *No restriction on ability of debtor to prepay; usually left to agreement of the contractual parties and rights of redemption are often available.*	• *Shari'ah allows a debtor to prepay at any time, even if (for most scholars) the contractual agreements expressly prohibit prepayment; most courts applying Shari'ah will probably determine similarly.*
Loss, Damage, Destruction and Consumption of Encumbered Asset	

• *No provisions are specifically applicable; subsumed as to some concepts in the concepts of proceeds (which includes insurance and condemnation payments, among others); local secular law will be of relevance.*	• *Base principles:*
	  • *Possession of trust (Hanafi; AAOIFI): secured creditor responsible for lesser of value of encumbered asset and amount of outstanding secured obligation; except where usurpation or transgression, then responsible for full value of encumbered asset.*
	  • *Possession of guarantee (Hanbali, Maliki, Shafi'i): secured creditor responsible for full value of encumbered asset in all circumstances.*
	  • *Proceeds are substituted for lost, damaged or destroyed collateral.*

	• *General rules: security right no longer valid upon total loss, damage or destruction unless proceeds are substituted.*
	• *Hanafis: loss, damage or destruction not attributable to debtor, secured obligation is repaid out of guarantee to lesser of outstanding obligation and asset value (secured creditor can claim for excess of outstanding obligation over asset value).*
	• *Non-Hanafis: possession of guarantee for full value of encumbered asset.*

	• *Malikis: possession of guarantee if any suspicion of usurpation, transgression or negligence of collateral that can be hidden (jeweler, e.g.).*
	• *Loss, damage or destruction in possession of 'adl is same as if possession by secured creditor (assuming 'adl did not place asset elsewhere (debtor or creditor) without requisite consents.*
	• *Notary holding: possession of trust, no responsibility absent transgression, usurpation or negligence (if so, possession of guarantee and notary responsible for value of asset and offset against secured obligation).*
	• *Leased or borrowed property: if lost in possession of secured creditor and debtor violated a property owner constraint in granting security right, debtor guarantees full value of asset as transgressor.*
	• *Leased or borrowed property, expressly for using as collateral: Hanafis have secured creditor liability for lesser of asset value and secured obligation; non-Hanafis have liability at full value of the asset; various rules on respective liabilities of debtor and secured creditor.*
	• *Property of others: Hanafis allow possession of guarantee liability against grantor and, if the secured creditor knew of the absence of legal right, the secured creditor; Hanbalis examine secured creditor knowledge, with full possession of guarantee if knowledge, and, if no knowledge, with different liability depending upon cause of loss, damage or destruction (e.g., negligence) and with three different liability rules.*
	• *Multiple Security Rights: full value from either first or second secured creditor, with first secured creditor ultimately liable (and invalidation of security right of secured creditor from whom compensation is not sought).*
	• *Failures to Pay Expenses Regarding Encumbered Asset: Hanafi: possession of trust liability to secured creditor (unless usurpation or transgression), with secured creditor claim against debtor if asset value is less than the outstanding secured obligation; Hanbali, Maliki and Shafi'i: possession of guarantee liability to secured creditor.*
	• *Use Arrangements: Impermissible debtor or secured creditor use makes the debtor or secured creditor liable for full value of the encumbered asset.*