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Brief Profile: Mr. Hairul Azmie Abd. Aziz is a Manager at the Islamic Banking and Takaful Department of Bank Negara Malaysia. Both Ms. Nor Liyana Azman and Mr. Wafiuddin Bin Ahmad are Associate Analysts at the Islamic Banking and Takaful Department of Bank Negara Malaysia.

Community Empowerment Initiative for Islamic Financial Institutions (IFIs)

"Risk-sharing in Islamic finance also extends to the creation of a more equitable and just distribution of wealth. Redistributive instruments such as obligatory almsgiving *(zakah)*, endowment *(waqf)* and charity *(sadaqah)* complement risk-sharing financing tools to form part of a comprehensive approach to address poverty and promote social justice within the community, aspects that are important in increasing the potential for a more balanced economic growth." **Dr. Zeti Akhtar Aziz** (Bank Negara Malaysia, 2013)

Introduction

This brief analysis of the relationship between Islamic financial institutions (IFIs) and community empowerment initiative is premised on two grounds: (i) a more holistic role of IFIs, i.e., not only to generate return to shareholders but also to create positive impact towards the community and; (ii) an enhanced intermediation role of IFIs. According to the Economic Planning Unit, 14% of the Malaysian population are low income earners, of which 1.7% are in poverty and 0.2% are in extreme poverty (Economic Planning Unit, 2013). The presence of poverty signals the need for IFIs to be part of social change. By empowering the society, every person will be able to participate in the economic development and thus contribute to future economic growth.

Today, a large number of IFIs are involved in Corporate Social Responsibility (CSR) initiatives to bridge income inequality in Malaysia. To create a more notable impact towards the community, IFIs may consider exploring the community empowerment initiative in two phases. Phase 1 would explore the potential of *waqf* and *sadaqah* as alternative sources of funding to finance various skills enhancement programmes and offer financial assistance such as *qard*,[1] cheaper rate of financing and *takaful* coverage. While Phase 2 would explore the potential of investment account as a source of fund to finance business needs of graduated *asnaf*.[2] Both phases involve different contributors to improve the well-being of the poor as well as to prevent them from falling back into poverty.

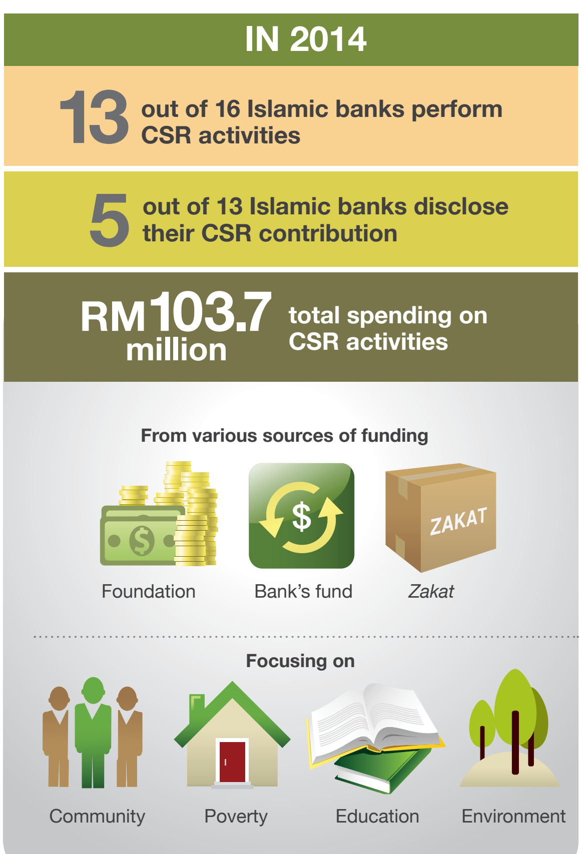
This article will briefly explain the above-mentioned, where the implementation of this initiative can be done by individual institutions or at industry level.

Corporate Social Responsibility Initiatives by Islamic Banks

In line with Islamic values that promote socioeconomic justice and equitable distribution of wealth, a large number of Islamic banks are currently involved in CSR initiatives to help the poor whom are disadvantaged and excluded from financial services.

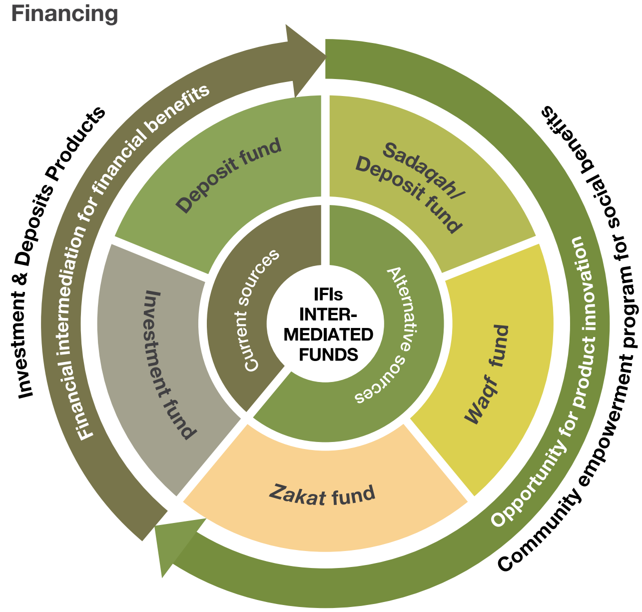
Over the years, it is observed that 13 out of 16 Islamic banks have disclosed their CSR initiatives. In 2014, five Islamic banks have spent more than RM100 million[3] obtained from various sources of funds. The majority of CSR initiatives across Islamic banks are focusing on community, poverty, education and environment. The current practices of Islamic banks are summarised in Diagram 1 below. For example, under the community category, the most common CSR initiatives include capacity building programmes, in which the poor are given opportunities to learn new skills that enable them to seek employment or start their own business. This is followed by disaster relief where financial assistance such as low interest loan and debt restructuring are given to those affected by natural calamities. In addition to the existing CSR initiatives, some Islamic banks are also offering *sadaqah* service where the public can transfer money directly from their savings account to specific charities.

Diagram 1: Capturing CSR initiatives amongst Islamic banks



Presently, the CSR initiatives are mainly funded by Islamic banks themselves. In order to fund more impactful initiatives, increased contribution from the public is central. To this end, Islamic banks may consider exploring alternative sources of funding such as *waqf* and *sadaqah*. By leveraging on alternative sources of funding as depicted in Diagram 2, Islamic banks are able to fund more initiatives that are impactful in the short and long run.

Diagram 2: Current and Alternative Sources of Financing



Phase 1: Integrating *Waqf* and *Sadaqah* Under the Community Empowerment Initiative

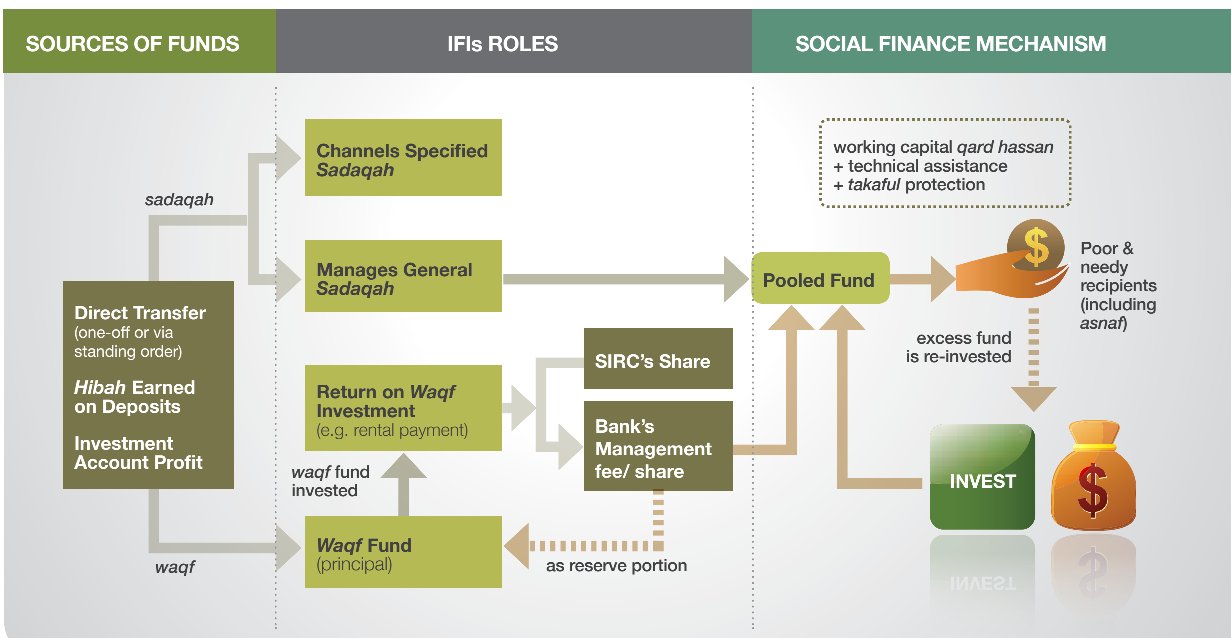
According to a research conducted by Charities Aid Foundation in 2014, Malaysia is ranked as the 7th most charitable nation (Charities Aid Foundation, 2014). To tap into this potential, Islamic banks may create pooled funds where the public can contribute a portion of *hibah* (gift) earned from their savings accounts or profits earned from their investment accounts in the form *waqf* or *sadaqah*.

Diagram 3 illustrates Phase 1 of the community empowerment initiative that integrates *waqf* and *sadaqah* as alternative sources of funding, whereby the Islamic bank will act as a fund manager of the pooled funds. In identifying *asnaf* that are eligible to receive assistance from the pooled funds, Islamic banks should collaborate with State Islamic Religious Councils (SIRC).

With the pooled funds, Islamic banks are able to finance various skills enhancement programmes such as sewing, electrical wiring and entrepreneurship skills to enhance the marketability and employability of the *asnaf*. In view that the poor also need a variety of services to cater for their financial needs, Islamic banks may also use the pooled funds to offer *qard*, particularly to micro-entrepreneurs who have limited access to finance. As the administration cost of disbursing the *qard* is absorbed using the pooled funds, the poor are then able to repay at affordable principal cost. In the case where larger scale of financing is required by the micro-entrepreneurs, the pooled funds can be combined with the deposit funds, allowing lower cost of financing to be offered.

> **"As the administration cost of disbursing the *qard* is absorbed using the pooled funds, the poor are then able to repay at affordable principal cost"**

Diagram 3: Phase 1 of the Community Empowerment Initiative



Role of Islamic Banks in Managing *Waqf* and *Sadaqah* Funds

As *waqf* and *sadaqah* entail dissimilar tenets, Islamic banks will have two different roles in managing these funds, summarised as follows:

- Administer specific as well as general *sadaqah*. *Sadaqah* received from the public is either for specific or general purposes. For specific *sadaqah*, Islamic banks will channel the contribution directly to specific charitable organisations that are recognised and eligible to receive charitable funds. For the general *sadaqah*, the contributions will be channelled to a pooled fund; and
- Manage and distribute return on cash *waqf* investment based on *mudarabah* (profit sharing) or *wakalah bi al-istithmar* (investment agent). In Malaysia, *waqf* is under the state purview. For Islamic banks to act as agent to collect cash *waqf*, they need to obtain consent from the state. Given the nature of *waqf*, where the principal must remain intact, the cash *waqf* received from the public will be treated as the principal fund. The accumulated principal fund will be invested by Islamic banks in various investment portfolios. Depending on the ratio agreed, the return on *waqf* investment will be distributed between SIRC (as a sole trustee of *waqf*) and Islamic bank. In regard to Islamic bank's portion, their share of profit or

wakalah fee can be channelled to the pooled funds. To prevent the principal fund from being depleted, the Islamic banks' portion may be partially retained as a reserve.

To facilitate the pooling of contributions by the public into these *waqf* and *sadaqah* funds, Islamic banks can also leverage on mobile applications as depicted in Diagram 4 as another possible distribution channel. With the availability of mobile applications, the public are able to contribute to charity, anytime and anywhere. In the UK and the US, mobile applications for charity such as Snapdonate, Check-in For Good and Charity Miles are widely available and used.

Diagram 4: Community Empowerment Initiative Through Innovative Products

With larger pooled funds in the future, Islamic banks can expand their initiatives to beyond helping the poor community. Islamic banks can also provide financial assistance to various humanitarian projects such as rebuilding houses in areas affected by natural calamities. Such initiatives would enhance the image and reputation of Islamic banks as well as heighten customers' confidence towards these institutions. To enable Islamic banks to continuously provide financial assistance until the poor become economically independent, the surplus from the pooled funds shall then be invested in various portfolios to create a self-funding mechanism.

Zakah as a Safety Net

Each year, Islamic banks will pay a certain amount of *zakah* payment to *zakah* centres. Some amount of the *zakah* payment is then returned by *zakah* centres to Islamic banks to be distributed to *asnaf*. In the event where the borrower fails to repay the *qard*, *zakah* distribution to *asnaf* will act as a safety net to prevent the poor from falling back into the poverty trap.

The default and distress borrower whom are eligible to receive *zakah* distribution will be nominated by the financing recovery unit. To manage moral hazard, the verification and validation must be done thoroughly by the Shariah section and must meet stringent criteria that are determined by the Shariah committee of the Islamic banks. This in turn will prevent negligent borrower from enjoying the benefits of *zakah*. The separate governance of the *zakah* payment and distribution would prevent misuse and 'cleansing' of the default financing, which is not the intended purpose.

Takaful Coverage Using the Pooled Funds

To enable the poor to have greater access to *takaful* protection, the pooled funds can also be used to pay for protection covers. To operationalise this, *takaful* operators need to be part of the community empowerment initiative by establishing a special *takaful* fund (in addition to risk fund and investment fund), where micro*takaful* coverage such as personal accident and *khairat* are offered based on the pure or mutual model. Using this model, payment of benefits upon occurrence of unfortunate events will be made subject to availability of the fund, thus minimising the cost of providing the coverage.

Phase 2: Financing Graduated *Asnaf* Through Investment Account

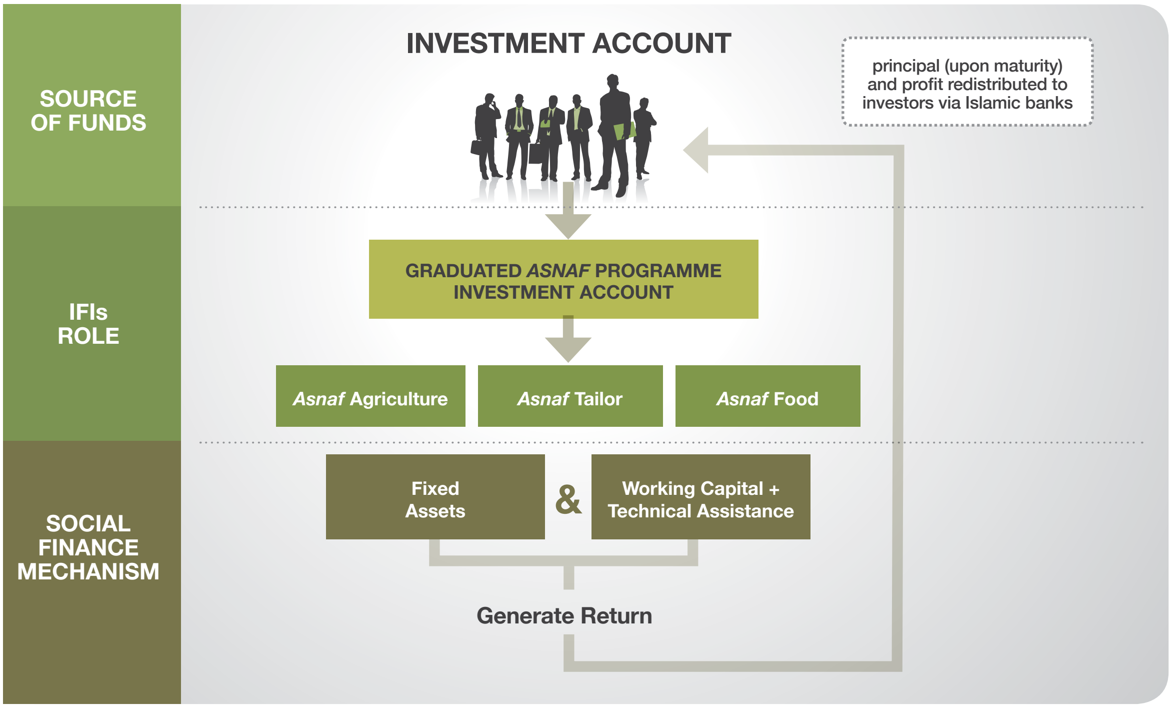
Once the poor and needy are able to pay for their own basic needs, they are no longer eligible to receive financial assistance from the pooled funds. During transitional stages from being unbankable to bankable, graduated *asnaf* may require financial assistance to enhance their current well-being and prevent them from falling back into poverty.

Diagram 5 illustrates Phase 2 of the community empowerment initiative that leverages on investment account as a source of fund to finance business needs of graduated *asnaf*.

The public with higher risk appetite will have the options of placing their surplus funds in investment accounts which will be used to invest in graduated *asnaf*'s business. Unlike Phase 1 of the community empowerment initiative where the risk is fully borne by the pooled funds, investment account promotes risk-sharing, whereby the level of returns depends on the performance of the business and the form of the returns is governed by the types of Shariah contract adopted.

Depending on the business needs, Islamic banks may provide working capital, technical assistance or fixed assets to help graduated *asnaf* to enhance their skills and knowledge to run business. Profits generated from the business shall then be distributed to investors.

Diagram 5: Phase 2 of the Community Empowerment Initiative



Conclusion

The integration of *waqf* and *sadaqah* under the community empowerment initiative completes the components of Islamic finance in Malaysia. With this article, it is envisaged that Islamic banks are able to explore the potential of the said initiative to promote social justice and equitable distribution of wealth. By effectively channelling the public's contribution and investment to the poor and needy, it will reduce income inequality gap in Malaysia.

Appendix

Overview of *Zakah*, *Waqf* and *Sadaqah*

The developments of *zakah*, *waqf* and *sadaqah* are primarily under the jurisdictions of each State Islamic Religious Council (SIRC). The federal government has no direct jurisdiction over Islamic law in the states. However, for the purpose of coordinating and increasing the efficiency of Islamic religious activities, the federal government through the Conference of

Rulers and National Council Fatwa Committee can take certain initiatives. In 2005, the Department of Awqaf, Zakat & Hajj (JAWHAR) was established by the federal government; specifically to oversee the development and management of these sectors. The following will briefly explain the developments of *zakah*, *waqf* and *sadaqah* in Malaysia, with focus on Islamic banks contribution toward these sectors.

a. *Zakah*

Zakah is a form of giving to those who are less fortunate. It is obligatory upon all Muslims to give a portion of one's wealth (2.5%-5%) each year to eligible *zakah* recipients. Over the years, *zakah* collection has shown an increasing trend as a result of advancement in technology that has made it easier for *zakah* payers to perform their financial obligation. The largest contribution to the pool of *zakah* comes from salary deductions, followed by corporate sector comprising companies and enterprises giving *zakah* on their business income (Obaidullah, 2015). According to the Fatwa Committee National Council of Islamic Religious Affairs Malaysia, a company is required to pay *zakah* when certain conditions are met.[4] Our finding shows that only 66% of IFIs pay *zakah*, whereas the rest are of the view that the obligation and responsibility of *zakah* payment lie with the shareholders. In general, the majority of Islamic banks adopted adjusted capital growth to calculate *zakah* payment. On average, 44% of Islamic banks distributed some portion of *zakah* payments themselves to selected *asnaf* recipients.

b. *Waqf*

Unlike *zakah*, *waqf* is voluntary. The act of giving *waqf* is encouraged in Islam as it benefits society at large. In the past, lands and buildings are the most popular forms of *waqf*, where profits generated from the *waqf* lands are used to address social needs such as education, healthcare and funding for small businesses. At present, there are around 11,091 hectares of *waqf* lands all over Malaysia valued at RM1.2 billion (Obaidullah, 2015). However, due to funding issues, not all *waqf* lands are being developed. Following that, various types of cash *waqf* concepts such as *waqf* shares, *takaful waqf* and corporate cash *waqf* were introduced by SIRCs as a way to raise funds to finance *waqf* activities. In 2008, JAWHAR established Malaysian *Waqf* Foundation to effectively manage *waqf* sources in Malaysia (Department of Awqaf, Zakat & Hajj, 2008). As part of the Islamic finance social agenda, a growing number of IFIs have jointly collaborated with SIRCs to participate in *waqf* development activities. For example, the joint collaboration between Selangor *Waqf* Corporation and Bank Muamalat Malaysia Berhad marks the first milestone of cash *waqf* in Malaysia, where *waqf* funds were channelled for education and health benefits (Bank Muamalat, 2012).

d. *Sadaqah*

Sadaqah is also voluntary. The difference between *sadaqah* and *waqf* is that *sadaqah* can be given to anyone, without any specific limits or rules. In Malaysia, there is no specific legislation which governs *sadaqah* since charitable organisations are subject to different laws depending on the establishment structure of the charity. In developed countries such as the United Kingdom and Australia, it is observed that a Charity Commission is established to govern charitable activities to preserve public confidence in giving charity. In this regard, we may wish to explore the establishment of a Charity Commission in Malaysia.

Disclaimer

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1 *Qard* is interest free loan where the borrowers are only required to repay the principal.
2 *Asnaf* are people who are eligible to receive *zakah* funds.
3 The figure includes three Islamic banks and two banking groups.
4 The company is owned by free Muslims; has complete ownership; the amount of wealth reaches the minimum *zakah* limit *(nisab)*; and wealth has been possessed for one lunar year.