Social Finance And Unconventional Financing Alternatives: An Overview

Paolo Pietro Biancone¹ and Maha Radwan ²

Department of Management, University of Turin, Italy, paolo.biancone@unito.it
Department of Management, University of Turin, Italy, maha.radwan@unito.it

Abstract— The economic crisis, the increment of poverty and unemployment, the emergence of several social problems, and the limitations of the public spending have all called for exploring innovative and alternative ways of social financing. Such enterprises face many challenges in accessing finance due to that high risk regarding generating profit, problems of governance model, and lacks of performance measurement valuations especially when it comes to measuring social value. There is a need for finance impact driven businesses and this requires the reinforcement of current funding alternatives and usage of innovative financing alternatives. Islamic finance with its unconventional wide range instruments represents a possible potentiality for offering innovative financing alternative. The paper is exploratory and should give insights to the emerging interest in both social impact finance and Islamic finance with its innovative tools that focus on risk sharing and social impact. This paper argues that unconventional financing alternatives could positively impact international economies and be a viable potential alternative for financing with its diversified instruments for social enterprises development. The paper explores the different unconventional instruments of financing as well as the criteria of accessing them. The paper provides insights for researchers, decision makers, and practitioners of how could be unconventional financing used as valid financing tool for social impact businesses.

Keywords- Social finance; Impact finance; Social entrepreneurship; Islamic finance; Sustainable development goals SDGs

I. INTRODUCTION

Recently, blending a social objective with businesses turned to be of a great importance after the economic crisis, increment of poverty and unemployment, emergence of several social problems, limitations of public spending, and the environmental changes problems. Governments lately have dedicated many efforts for supporting entrepreneurship and entrepreneurs as this impact positively the whole economy. Social entrepreneurship is not limited to creating employment opportunities and improving economic growth; but it contributes to the well-being of the community [1]. According to [2], [3] entrepreneurship accelerates the economic development. It also contributes to increasing wealth and income, and linking of the domestic economy to the international one.

Policy makers around the globe are giving high attention to social impact investments on the basis that enterprises goals are to have both economic and social benefits to the community and the relevant stakeholders. "Impact investing means investing money with a positive social impact". Blended finance, in the words of the OECD, is defined as “the strategic use of development finance for the mobilization of additional commercial finance towards the Sustainable Development Goals (SDGs)”. This strategic use shall lead to positive results for both investors and communities.” Using various Islamic financial instruments like zakat, waqf, microfinance and sukuk could be a potential solution and fitting perfectly with this type of investments for achieving sustainable development goals. All these instruments are possible tools for poverty alleviation, enhancing financial inclusion and maintaining sustainable growth.

Islamic finance industry has experienced progressive growth in the last years whether for Muslims or Non-Muslim countries [4]. According to the [5] Islamic finance assets have a compound annual growth rate of 12.7%. Worth mentioning that; UK and Switzerland were listed in the top 20 largest countries in total Sharia-compliant assets. Conventional financial institutions have extended their operations to provide Islamic financial products targeting Islamic investors. It was referred that entrepreneurs financing by banks has been gradually increasing in most of the countries where Islamic banks operate and this is because of more awareness and greater supply where entrepreneurs who would previously have used conventional financing have now started demanding Islamic products.

The dynamically increasing importance of the culture and religion in developing impact finance can be seen especially when religion has a positive approach towards it [6]–[8]. Muslims counts for around 24% of global population and Islam
is the world’s second-largest religion with the fastest growth rate [9].

Although of the high expectations and the positive outlook, the Islamic finance full potential is not yet realized. Expanding to new innovative financial tools is required for achieving the sustainable development goals. This could be reached by achieving the optimal linkage for bridging from theory to practice with developing tools that can take into consideration the aspects of both risk-sharing and social impact [10], [11].

A plenty of researches have been conducted on impact finance from different prospective, there has been very few literature and studies that takes into consideration the connection between Islamic finance and impact finance [12]. The motivation of this paper comes from the global progressive interest supporting social impact investments, where a research on the linkage between Islamic finance and impact finance is intensively needed and particularly important. This paper is exploratory and conceptual in nature that provides insights for researchers, decision-makers, and practitioners of how could be Islamic finance used as a valid financing tool for social impact finance.

This paper is organized as follows: section two starts with an overview of Islamic finance in a way that explores its principles and its relation with social impact finance. In section three we provide the criteria of having businesses Sharia compliant and give insight on the possible mechanisms of financing. Section four investigates the potential of the Islamic finance industry. Section five discusses the instruments of Islamic financing and exploring how it could be valid for supporting impact investments. Finally section six concludes.

II.  ISLAMIC FINANCE: AN OVERVIEW

Islam as a religion emphasizes the betterment of society and goodwill among humans; therefore all activities of Muslims are to be centered on upholding the highest ethics and social responsibility. Islamic teachings emphasize the duties of Muslims towards humanitarian and social welfare [13]. It urges for maintaining social justice, equity, and poverty alleviation [14], [15].

Islamic finance with it various financial products is not limited to Muslims but on the contrary available to everyone [16], [17]. What makes Islamic finance attractive to the Western countries is that this financial system operates in an ethical way that is very close to the socially responsible investments [18]. Islamic finance is considered one of the fastest growing areas of the global financial industry and its diffusion in the Western markets illustrates how it is attracting the attention of the investors, financial institutions and regulators as a valid alternative to conventional one [19].

Islamic finance instruments requires that all financial transactions following the Sharia doctrine. Sharia is the set of rules derived from the primary sources (Quran and Sunna) and secondary sources (Ijma and Qyias) covering all aspects of a Muslim’s religious, political, social, and economic life [20], [21]. These Sharia principles have a fundamental concept that God is the owner of the whole world as well as the whole wealth. Muslims have the right to enjoy their wealth providing that it is realized or invested in a way that is adhering to Sharia principles. Referring to these Sharia principles it consists of prohibitions and obligations. As for the prohibitions; 1) Prohibition of Riba (usury/interest), 2) Prohibition of Gharar (speculation/uncertainty), 3) Prohibition of Maysir (gambling), 4) Prohibition of investing in Haram (unpermitted) activities and business like alcohol, tobacco, pork-related products, adult entertainment (pornography), and weapons [18], [22]. Adding to all previous prohibitions there are some obligation principles; 1) Investments should be asset-backed or identified to an underlying tangible assets, 2) Application of the Profit and loss concept (PLS) where risk should be shared among all business involved parties [23], 3) The obligation of Zakat (charity) where a specific percent declared by Sharia should be dedicated to the poor and needy which really reflects a strong linkage between Islamic finance and impact finance and investing.

In light of the above, the Islamic financial instruments can be considered in line with the same objectives and requirements social impact investments that generate social and economic benefits.

III.  SHARIA COMPLIANCE CRITERIA AND FINANCING MECHANISMS

The strong correlation between business and Sharia principles has strong consequences on the business activities where investments or earnings should be Sharia compliant [24]–[26]. The ownership of any share of a company or investing in a business or being a partner in a business within the Sharia concept should be done in a full adherence to the Sharia principles In other words to attract Muslim investor the business should be Sharia compliant. Sharia compliance signifies that businesses are prohibited from being engaged in activities like alcohol, tobacco, pork-related products, adult entertainment (pornography), and weapons as well as their financial structure should be free of interest (usury), speculation, gambling, and uncertainty. Moreover, the level of interest, the level of liquidity, and the level of leverage in any enterprise that Muslims should invest in should not exceed certain threshold.

Islamic financing mechanisms have different alternative forms and transactions from the conventional financial institutions in which they do not deal with interest. There are two alternative mechanisms of financing; equity financing or debt financing. Starting by the equity financing there are two famous financing structures that are considered Sharia-compliant financing mechanisms namely Mudaraba (partnership) and Musharaka (joint venture) where those contracts are based on the profit and loss sharing a principal. As for the debt financing alternative that are all sale contracts
are Murabaha (cost plus markup), Ijara (leasing), Istisna (construction).

IV. POTENTIALITY OF ISLAMIC FINANCE

According to Pew Research Center, Islam is the world’s second-largest religion with the fastest growth rate and Muslims are also considered to have the youngest population and the highest fertility. Muslims represented almost 24% of the world population in 2010. As for Muslim population in Europe, had reached 44 million in 2010 [9]. Estimations for 2050 indicate that Muslims will reach almost 30% of the worldwide population, and as for Europe they will reach 71 million [27]. Islamic finance could bring high liquidity into the financial mainstream and possibilities of raising capital from Muslim countries should not be under-evaluated [28].

Traditional financial institutions have expanded products and services to provide Islamic financial products. The Islamic finance has a various array of products from Islamic micro lending and microfinance to the issuance of “sukuk” (Islamic bonds) [29], [30].

The Islamic finance industry has an accelerated growth rate globally where; Islamic finance assets have a compound annual growth rate of 12.68% with Sharia compliant assets totaling $1.273bn [4].

Islamic markets also provide various instruments that serve as the base for developing a wide range of sophisticated financial instruments that are highly innovative [31].

V. ISLAMIC FINANCE AND IMPACT INVESTING

Muslim communities have some ways that might solve the problem of finding innovative ways of financing specially for infrastructure that are majorly capital intensive which is the development of instruments like waqf, zakat, sukuk waqf, Sharia compliant crowd funding, and microfinance as an efficient instruments to secure sustainable financing for the growing needs for impact investments. The adoption of zakat and waqf instruments for example aims to combine both religious duty of charitable spending and economic development.

There is incomparable opportunity to alleviate poverty using the untapped potential of Islamic finance. Alleviating poverty is one of the goals of the Sustainable Development Goals (SDGs) as long as reducing inequalities and many other social goals in addition to other economic and environmental goals. The Islamic Development Bank (IDB) and the UNDP issued a report “I for Impact: Blending Islamic Finance and Impact Investing for the Global Goals” that is considered a key step forward in conceptualizing Islamic finance-based impact investing, and building an ecosystem in support of this idea. The strategies and approaches to leverage Islamic financial instruments, like sukuk and micro-takaful and other relevant instruments were highly praised by investors. However, between US$3 trillion and $4.5 trillion is needed annually to achieve the SDGs, while current investment in relevant sectors is around $1.4 trillion, creating a financing gap around $2.5 trillion. Governments alone cannot fulfill SDGs goals and increased needs for accessing the opportunities of social finance and private sector investments. Islamic finance has various array of social instruments demonstrated in waqf, microfinance, and sukuk and many others that are able to offer a possibility of achieving the SDGs, by embodying socially responsible development, and by bridging opportunities for economic growth and social welfare, particularly for the poorest and most vulnerable. Striking commonalities exist between zakat and other forms of Islamic finance, and the SDGs, with their common focus on alleviating poverty and hunger and reducing inequality by redistributing wealth.

Zakat is an annual obligation of charity of giving comprising at least 2.5 percent of income or wealth that is paid by all Muslims having their income or wealth above a certain threshold. Zakat can have a key important role in reducing and preventing poverty by redistributing wealth to all parts of society. The worldwide value of zakat alone is potentially US$200 billion to US$1 trillion annually. However, this extraordinary potential has yet to be fully realized, even in the world's largest Muslim-majority country, because informal giving of zakat remains much larger than contributions made through formal Islamic organizations. Thus, a model shift is needed in the management of zakat, moving from a focus on the charitable act of giving to its impact in expanding the rights of the recipients. A shift is needed as well from individual spending on consumption for basic needs, to broader focus on productive activities.

Zakat can combine with other sources of Islamic finance to support entrepreneurship and expand financial inclusion through the following sharia compliant instruments and mechanisms: (1) redistribution of wealth, through zakat, sadaqa, waqf and qard hasan, and (2) usage of risk-sharing based financing via microfinance of small and medium enterprise [32].

Microfinance aims to combat the exclusion of the most deprived from the conventional banking system through the creation and development of microfinance institutions. Indeed, it is an alternative for low - income households to create income - generating activities, to raise assets and to improve their socioeconomic status. In other words, microfinance is designed to combat the different dimensions of poverty. Obviously, the microfinance concept referred to microcredit. Nevertheless, it extends beyond credit to cover financial services adapted to the specific needs of the poor who represent its main target (savings, insurance, money transfer). The Islamic financial system is based on principles of social solidarity and equity that coincides with the objectives of microfinance. [33]. According to the Consultative Group to Assist the Poor (CGAP), the supply of Islamic microfinance is very limited, with a high concentration in East Asia and the Pacific at 92%, the Middle East region at 64%. These institutions allow this category to have access to the various financial services on a micro level by enabling them to improve their living conditions and fight against poverty [34].

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Islamic microfinance offers interest-free contracts that are Sharia compliant and can support the poor by contributing to productive activities, increasing revenues and savings, and allowing the generation of capital. There are three sources of finance: 1) Donations based on tabarru (a voluntary charitable action) can include zakat, sadaqa, waqf (an endowment made by a Muslim to a religious or charitable cause) and hibah (gift); 2) Deposits including wadiah (safekeeping/custody/trust), qard hasan (benevolent loan); and 3) Equity including mudarabah (a partnership where one party provides capital and the other party provides expertise and musharakah (a partnership where each party contributes to the capital). Funds can be collected by the Islamic responsible institution from members of the community in the form of zakat and sadaqa, and to redistribute the funds to those entitled to receive them, or to loan to members who need them due to financial distress, through qard hassan financing products (benevolent loan or zero-percent interest).

Moving to another tool from the vast array of instruments that Islamic finance can provide is; crowd-funding which could be described by obtaining small portion of money from high number of people for funding particular project through an online platform with providing that the whole process, project and transactions are all Sharia compliant. Crowd funding has a potential to be the next successful financial innovation in Islamic finance. The Islamic crowd funding could be based on one of the following tools: (1) Zakat-based, (2) Sadaqa-Waqf-based, (3) Qard- hasan-based, (4) Equity-based (Mudharabah and Musyarakah) and (5) Lending-based (Murabaha, Ijarah, Istishina, etc) [35]. Islamic crowd funding cost effective way for Sharia-compliant equity financing [36]. Equity-based crowd funding provides access to capital to wide range of entrepreneurs, provide a valid alternative for financing SMEs, reduce the risk through diversification of multiple projects, and finally promotes innovation, and reduce unemployment. Based on Alonso (2015) the first Sharia compliant crowd funding services in the world are based in Egypt, namely; Shekra.com as an equity based model and Yomken.com as a microfinance model [37].

Islamic financial instruments face several challenges requires both strengthened accounting standards and more expertise and qualified people, and many efforts are needed to raise the awareness of such instruments [29], [38]–[41]

While the potential role for zakat is increasingly being harnessed for sustainable development, the role of waqf is not of a less importance. Waqf is also a charitable form is more flexible than zakat with long term duration, and can be used for economic growth and income generation. Generally, waqf involves donating a land, building or any asset for religious or charitable purposes, with no intention of reclaiming this asset. Lately in a UNDP innovative financing discussion; there was a consideration of using waqf as a social impact financing tool. The word Waqf in Arabic refers to the “stopping” (one basic meaning of the Arabic root verb, Waqafa) of some piece of property. Certainly, it is not permissible to set up a Waqf for purposes that are not Sharia compliant. On the other hand, there is consensus among Sharia scholars that it is permissible for Non-Muslims to both start a Waqf and also be considered for receiving benefits of a Waqf endowment. Waqf have several benefits like; the development of a social capital market and increase social investment, raising awareness of rich people on their responsibility for social development, and enhancing the integration between social security and social welfare [13].

While zakat, Islamic microfinance and waqf are largely charitable forms of funding, sukuk (Islamic bonds) are a commercial instrument to attract financing. Unlike conventional bonds which are a debt obligation, the presence of underlying assets in sukuk is compulsory for it to be compliant with sharia. As sukuk grant partial ownership in the underlying assets proportional to its value. The issuance of sukuk is usually intended for general funding purposes or for financing infrastructure projects, such as power plants, ports, airports, hospitals and toll roads [29]. Sukuk can leverage private finance for investment in infrastructure in areas where SME development is taking place thereby providing a local economic environment where SMEs are more likely to thrive. It could be implemented under the scheme in which waqf lands are used for underlying sukuk issuance [42] In addition, the return of the sukuk could also be utilized for financing MSMEs through Islamic microfinance.

VI. CONCLUSION

Recently, blending a social objective with businesses turned to be of a great importance after the economic crisis, increment of poverty and unemployment, emergence of several social problems, limitations of public spending, and the environmental changes problems. Governments lately have dedicated many efforts for supporting entrepreneurship and entrepreneurs as this impact positively the whole economy. The need for new strategies that are innovative in terms of models, tools, and instruments is necessary. One of the new innovative financial resources is the impact investments, where funds are allocated from investors who are seeking investments that generate both social and economic value. Islamic teachings emphasize the duties of Muslims towards humanitarian and social welfare [13], and the unconventional financing alternatives can be considered in line with the same objectives and requirements social impact investments that generate social and economic benefits. The dynamically increasing importance of the culture and religion in developing impact finance can be seen especially when religion has a positive approach towards it [6]–[8]. Although of the high expectations and the positive outlook, the Islamic finance full potential is not yet realized. Expanding to new innovative financial tools is required for achieving the sustainable development goals. This could be reached by achieving the optimal linkage for bridging from theory to practice with developing tools that can take into consideration the aspects of both risk-sharing and social impact [10], [11].

The paper had explored the various arrays of the unconventional financing alternatives provided by Islamic finance that can be used in impact investing. The UNDP in an
exploration of Islamic finance potential in impact investing assured that impact investing and Islamic finance are highly complementary as both of them uphold rigorous moral and social criteria for investments and emphasize on inclusiveness. The paper had shed the light on the wide range of Islamic financial products like equity based financing based on profit or loss sharing (musharakah and mudarabah), debt financing tools, charitable instruments like (zakat, waqf, sadaqa, and qard Hassan), more over micro credit loans, microfinance, crowd funding. Accessing such financing instruments requires that business core activities and financial transactions and business model all fully compatible with the Sharia principles.

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