

# Social Finance and Financing Social Enterprises: An Islamic Finance Prospective

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**Abstract**— Enterprises that have a dual objective of generating positive social impact and financial economic benefit turned to be vital with the increased level of poverty and other major social problems accompanied with limited public spending. The growth and development of social impact enterprises is fundamental for all economies and financing them is a challenging issue where they struggle to accessing finance. Traditional financial instruments are difficult to access especially after the recent financial crisis due to that social enterprises face high risk regarding generating profit, problems of governance model, and lacks of performance measurement valuations especially when it comes to measuring social value. On the other hand, Islamic finance has experienced progressive growth in the last years and could play significant role not only limited to Muslims but also for Non-Muslim countries. Advances in Islamic Finance and Social Finance demonstrate an increasing global attention for finding alternative ways of financing and creating value in the society since both of them have similar ethical dictates. Sharia that regulates all Islamic financial instruments and investments and its screening methodology prohibits unethical businesses and practices that are similar to the negative screening methodology adopted by the socially responsible investment which make both of them connected to Social Finance. This paper is exploratory in nature and argues that Islamic finance could be a viable potential alternative with its diversified instruments for financing social impact enterprises. The paper provides insights for researchers, decision makers, and practitioners of how Islamic finance provide valid financing tools for social finance through mobilizing private funds allocated from investors who seeks investments that generate both social and economic value.

**Keywords**- Social finance; Islamic finance; Impact finance; Social enterprises; Sharia compliant

## I. INTRODUCTION

The increment of poverty and unemployment, the emergence of several social problems, the limitations of public spending, and the environmental changes problems have all called for an innovative approach for overcoming such social problems through blending a social objective with businesses. Social entrepreneurship emerged in the private, public and non-profit sectors to reduce social problems, alleviate poverty and to strengthen the relationship between entrepreneurs and

society from perspectives such as charity and philanthropy as well as social services [1], [2] Social entrepreneurship is an emerging area of research which examines business that is significantly influenced by social impact instead of being purely economically driven [3]. Social entrepreneurship turned to be a phenomenon that impacts the society by employing innovative approaches to solve social problems [4]. Social entrepreneurship is not limited to creating employment opportunities and improving economic growth; but it contributes to the well-being of the community [5]–[9].

The social enterprises is considered a catalyst for the development of civil society and the need for their advancement through new strategies that are innovative in terms of models, tools, and instruments is necessary. Focusing on social impact enterprises that have a dual objective of generating positive social impact and financial economic benefit is fundamental for all economies however on the other hand financing them is a challenging issue where they struggle to have access to finance. Social enterprises face many challenges in accessing finance due to the high risk regarding generating profit, problems of governance model, and lacks of performance measurement valuations especially when it comes to measuring social value. Social enterprises seek finance from banks, venture capitals, grants, public funding, and others but traditional financial instruments are difficult to access for such enterprises especially after the recent financial crisis. The public sector and governments are urged for finding innovative and alternative sources of financing like for example tapping the Islamic financial instruments as an alternative. Islamic finance has many principles that makes it very close to social finance like risk sharing and calls for social justice and welfare. 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 [10]–[12].

There are solid evidences in Islamic history for financing the social sector using Islamic financial tools like zakat (obligatory charity) sadaqa (voluntary charity) and waqf (perpetual endowment). These financial tools participated heavily in the development of public facilities and services in the past; where it has meant reduced burden on the part of the government to raise for public spending; it is considered a clear notable beneficial effect that a well-designed waqf system can have on a country's ethical, social, and economical status [13].

Therefore, Islamic finance could play a big role to enhance the development of the social enterprises expanding its universe of sharia compliant products to develop more innovative instruments that provide solutions to social problems and promote social welfare. Islamic financial instruments like zakat, waqf, microfinance and sukuk (Islamic bonds) could be a potential solution and fitting as tools for poverty alleviation, enhancing financial inclusion and maintaining sustainable growth.

Islamic finance industry has been growing remarkably in the previous years whether for Islamic or Western countries [14] where Muslims counts for around 24% of global population and Islam is the world's second-largest religion with the fastest growth rate [15]. According to the Banker [16] Islamic finance assets have a compound annual growth rate of 12.7%. While Western countries like 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. Moreover, entrepreneurs financed by banks have been gradually increasing in most of the countries where Islamic banks operate and this is because of more awareness and greater supply for entrepreneurs who have started demanding Islamic products.

Despite of the expansion and growth of Islamic finance in the previous decades, but the full potential is not yet realized specially in the social arena [17]. Expanding to new innovative financial tools is required that could be reached by developing tools that can take into consideration the aspects of both risk-sharing and social impact [13], [18]. There is a criticism to Islamic finance industry concerning the lack for innovative solutions for social objectives like for example mobilization of zakat and sadaqa endowment funds to create financing for sustainable social projects for making a difference on welfare of societies. In addition, institutions that regulate and manage zakat funds were often been described as incompetent and inefficient [19].

A plenty of researches have been conducted on social finance from different prospective, there has been few studies that takes into consideration the connection between Islamic finance and social finance [20]. The motivation of this paper comes from the global progressive attention towards supporting social impact e and empowering social enterprises, where a research on the linkage between Islamic finance and social finance is highly important and necessary as well as developing new models to expand the universe of sharia compliant financial instruments which can provide financing for projects with social returns. 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 finance. This paper is organized as follows: section two starts with background of Islamic finance in a way that explores its principles and its relation with social finance. In section three we provide the screening methodology of businesses to be considered Sharia compliant. Section four discusses the instruments of Islamic financing and exploring how it could be

valid for supporting social finance. Finally section five concludes.

## II. ISLAMIC FINANCE: BACKGROUND

Islamic religion calls for a comprehensive development of an economy and puts emphasis on social welfare and urges for maintaining social justice, equity, and poverty alleviation [21], [22]. Its teachings stresses on the duties of Muslims towards humanitarian and social welfare [23]

The concept of the maqasid al sharia (purpose of sharia) upholds the principle of serving the public interest of maximizing benefit and reducing harm of the community. Thus eradication of poverty, socio-economic justice are among the primary goals of Islam [24] that is based on adl (social justice) and ihsan (benevolence) [25], [26] which makes Islamic finance attractive to the Western countries is that this financial system operates in an ethical way similar to the socially responsible investments [27]. In addition, Islamic finance with it various financial products is not limited to Muslims but on the contrary available to everyone [28], [29] and this is confirmed by its diffusion and ability in attracting the attention of the investors, financial institutions and regulators as a valid alternative to conventional one [30].

Islamic financial instruments should all follow the Sharia dictates. Sharia are the set of rules derived from the main resources Quran and Sunna and other sources like Ijma and Qyias (consensus and analogy) covering all aspects of a Muslim's life [31], [32]. Sharia prohibits; 1) Riba (usury/interest), 2) Gharar (speculation/uncertainty), 3) Maysir (gambling), 4) Investing in Haram (unpermitted) activities and business like alcohol, tobacco, pork-related products, adult entertainment (pornography), and weapons [27], [33]. Moreover some other concepts should be maintained like; 1) Investments should be asset-backed or identified to an underlying tangible assets, 2) Application of the Profit and loss concept (PLS) [34] , 3) Fulfilling the obligation of Zakat (charity) towards the poor and needy.

The Islamic finance have a various array of products from Islamic micro lending and microfinance to the issuance of "sukuk" (Islamic bonds) [35], [36]. Given the main problem is lack of financial access; alleviating poverty will be creating wealth through development of social enterprises; Islamic tools could support social enterprises as a way to empower the poor and graduate from poverty through micro financing, zakat which is obligatory , and waqf as an voluntary charity.

## III. SHARIA COMPLIANCE SCREENING

Due to the requirements of the sharia screening criteria for qualitative and quantitative criteria since investments should be always a Sharia compliant. The qualitative criteria are mainly related to the business activity of the company and it permissibility according to Sharia and the quantitative criteria are a set of financial ratios and levels that had to be examined. Islamic finance could be seen as part of social finance which

can be defined as an approach to mobilizing private capital that delivers a social dividend and an economic return to achieve social and environmental goals. Both Islamic Finance and Social Finance have many similarities in terms of ethics and social goals. For example both exclude companies with business activities (qualitative criteria) which are considered unethical like: alcohol, tobacco, weapons and pornography. Passing this initial qualitative screening phase means moving towards a quantitative financial screening. In addition, financial structure (quantitative criteria) should be free of interest (usury), speculation, gambling, and uncertainty [37]. Thus a financial screening for 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.

The strong correlation between business and Sharia principles has strong consequences on the business activities where investments or earnings should be Sharia compliant [38]–[40]. 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. Sharia compliant usually done through negative screening where it ensures investors that the money they invested is not used to support investment that is prohibited by Islam, these investors are not given the opportunity to affirm their belief in a more positive manner, that is to pro-actively direct investment to areas which have important impacts from the maqasid sharia point of view.

#### IV. ISLAMIC FINANCE TOOLS FOR SOCIAL FINANCE

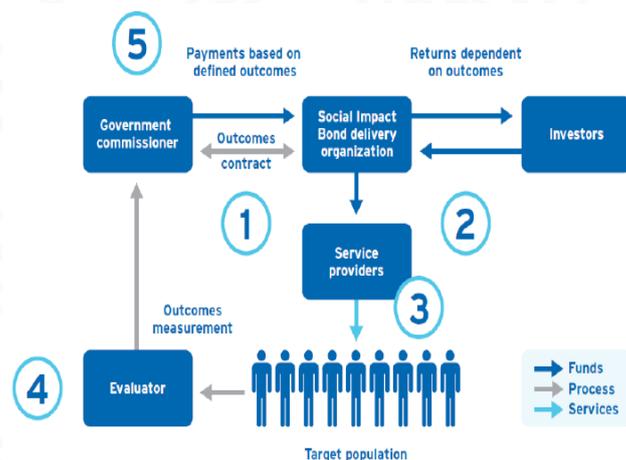
Finding innovative ways of financing especially for social impact enterprises could be found in tools like waqf, zakat, sukuk waqf, Sharia compliant crowd funding, and microfinance. One of the new innovative financial resources is the impact investments, where funds are allocated from investors who are seeking investments that generate both social and economic value. A social business is a social objective oriented entrepreneurship that applies commercial strategies to maximize improvements in human well-being rather than maximize profits [41]. Social business is expected to bridge the gap of the public and private sectors to achieve their socio-economic goals. This type of social business similar to Islamic finance for having a main primary scope of community benefits, rather than individual benefits. 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 idea of social impact enterprise is increasingly gaining attention due to its stability for income generation while offering societal contributions. The social enterprise is known in the Western countries with a concept of that surpluses earned would mainly be reinvested in the business or in the community-oriented, rather than being driven for maximizing shareholders’ wealth-oriented [42], [43]. Thus having a dual objective of

financial sustainability and social purposes [44]. Islamic finance has various array of social instruments demonstrated in waqf, microfinance, sukuk and social impact sukuk and many others that are able to offer a possibility bridging opportunities for economic growth and social welfare.

Social impact bond (SIB) is an innovative way for public, private and not for profit organizations to cooperate to achieve social outcomes. The funds are raised from investors who are seeking investment with social impact for better social outcomes. The SIB is a series of pay-for success contracts where private investors provide capital and the government agrees to repay them for successful achievements of social outcomes. If the project leads to a positive social outcome then the investors will receive their capital along with an additional return [45]. However, if the SIB project is not successful, the investors may lose their entire investments [46]. The SIB model is a multi-stakeholder partnership approach involving public, private, and the social sector according to the model structured in the figure I by So & Jagelewski (2013) where it functions as follows: At first the government assign a SIB and negotiates with other stakeholders the agreement regarding the outcomes and payments terms and conditions. Then the SIB delivery organization issues bonds to be sold to investors to raise funds that will provide capital for the project. The third step is that the social service provider receives the funds and it will be used to finance the delivery of services to the target population. Afterwards, an independent evaluator control and evaluate the outcomes and then report it to the government. The final step is mainly based on the report issued by the independent evaluator where in case of the agreed outcomes are achieved, the government makes the necessary payments to the investors.

FIGURE I: STRUCTURE OF SIB



Source: So & Jagelewski (2013)

The first social bond launched in 2010 was the Peterborough social impact bond in the UK, followed by others like the New York City social impact bond in 2012 raising USD\$9.6m capital and the Newpin social benefit bond in New

South Wales in 2013 raising AUD\$7m capital. These social bonds are innovative tool as solution in the social problems. The social enterprises often lack funding and with governments in many countries having huge debt problems, such social impact bond could be used as tool to help raise finance to provide solutions to social problems. Islamic finance has the social impact sukuk developed to provide financing solutions for some of the social issues in the community. As an example for the social impact sukuk is the vaccine sukuk which was launched in 2014 by the International Finance Facility for immunization (IFFIm) with the World Bank issued the debut Vaccine sukuk worth USD500 million. The success of the inaugural transaction led IFFIm and the World Bank to issue the second vaccine sukuk in 2015, worth another USD200 million [46].

Though the strong potential of the social impact sukuk but it is still a new tool that needs to be expanded and well-structured in the future to get its full power. Thus other tools are considered to be also significant to be explored to their full capacity like for example Zakat which is an annual obligation of charity of giving 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. Zakat can combine with other sources of Islamic finance to support social enterprises 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 [37].

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. The Islamic financial system is based on principles of social solidarity and equity that coincides with the objectives of microfinance. [47]. Islamic finance, hence, offers a moral approach through a profit and loss-sharing approach in the form of musharakah and mudarabah modes of financing [48]. 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). Islamic finance can provide also crowd-funding which could be described by obtaining small portion of money from high number of people through an online platform in a Sharia compliant manner. Islamic crowd funding is seen as a cost effective way for Sharia-compliant equity financing [49]. Equity-based crowd funding provides access to capital to wide range of finance to entrepreneurs providing a financing mobilization of resources.

The role of waqf that is a charitable form that involves donating a land, building or any asset for religious or charitable purposes, with no intention of reclaiming this asset. 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 [23]. Establishing waqf-based financing institutions serving the poor is highly beneficial [50], [51] Sukuk can leverage private finance for investment in infrastructure in areas where social impact enterprises development is taking place thereby providing a local economic environment where they are more likely to thrive. It could be implemented under the scheme in which waqf lands are used for underlying sukuk issuance [52] In addition, the return of the sukuk could also be utilized for financing micro enterprises through Islamic microfinance. 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 [35].

## V. CONCLUSION

Social impact enterprises that have a dual objective of generating positive social impact and financial economic benefit is fundamental for all economies however on the other hand financing them is a challenging issue. The social enterprises is considered a catalyst for the development of civil society and the need for their advancement through new strategies that are innovative in terms of models, tools, and instruments is necessary. The public sector and governments are urged for finding innovative and alternative sources of financing like for example tapping the Islamic financial instruments as an alternative. Islamic finance has many principles that makes it very close to social finance like risk sharing and calls for social justice and welfare. There are solid evidences in Islamic history for financing the social sector using Islamic financial tools like zakat (obligatory charity) sadaqa (voluntary charity) and waqf (perpetual endowment). These financial tools participated heavily in the development of public facilities and services in the past. In light of what explored, the Islamic financial instruments can be considered in line with the same objectives and requirements social impact investments that generate social and economic benefits.

However, despite of the expansion and growth of Islamic finance in the previous decades, but the full potential is not yet realized specially in the social arena [17]. 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 [35], [52]–[55]. The paper had explored the various arrays of financial instruments that can be used in social impact investing. We argue that the Islamic finance with its ethical principles represents a possible potentiality for offering innovative financial instruments for achieving social goals where social 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 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 Sharia compliant. The screening methodology is usually done through negative screening where it ensures investors that the money they invested is not used to support investment that is prohibited by Islam, while we recommends it to be done by giving opportunity to the investors to affirm their belief in a more positive manner, that is to pro-actively direct investment to areas which have important impacts from the maqasid sharia point of view.

The paper highlights these tools and look at their potential, especially in promoting ethical and social impact investments. Social impact bond (SIB) which is an innovative way for public, private and not for profit organizations to cooperate to achieve social outcomes. The funds are raised from investors who are seeking investment with social impact for better social outcomes. Islamic finance offers the social impact sukuk that are still nascent, for example for the vaccine sukuk which was launched in 2014 by the International Finance Facility for immunization (IFFIm) with the World Bank issued the debut Vaccine sukuk worth USD500 million and the success of the inaugural transaction led to issue the second vaccine sukuk in 2015, worth another USD200 million. Therefore, the issuances of social impact sukuk can potentially tap into the needed expansion and reinforcement of the Islamic finance industry to achieve maqasid al Sharia that upholds the principle of serving the public interest of maximizing benefit and reducing harm of the community. The paper suggests that growth in this landscape within Islamic finance should be supported availability of supply. Due to the huge potential of the sharia social impact space, the paper recommends for identification of areas where products such as sharia compliant social impact sukuk could be structured.

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