Ville Valtteri Korpela, Doctoral Student, Finland Futures Research Centre, University of Turku. Rehtorinpellonkatu 3, 205400 Turku, Finland. Email: vivako@utu.fi, mobile: +358405013695.

Petri Kuusisto, Founding Partner, Impact Innovation Institute Oy Ltd, Yhtiöntie 8, 02700 Kauniainen, Finland. Email: petri@impact-institute.net, mobile: +358405596975.

Anisa Tahiri, Research Assistant, Impact Innovation Institute Oy Ltd. Email:anisa@impact-institute.net, mobile: +355676716999.

CONNECTING ISLAMIC FINANCE WITH IMPACT INVESTING

1.Introduction

Nowadays, the challenges of sustainable development, such as poverty, social inequality, and environmental hazards far exceed the capacities of governments and philanthropy. In this regard, the 2030 Sustainable Development Agenda foresees the reactivation of a global partnership for sustainable development. In the present article, we focus on examining the connection between Islamic finance with Impact investment. We highlight the cultural values being the background on both sides.

Through the literature review, this study aims at exploring how Islamism and Islamic culture has influenced sustainable development practices over the years and the way Islamic religious norms relate to sustainable development objectives. We will also focus on highlighting the risk sharing principles as a beneficial concept for creating impact through investments.

2. Islamic Finance and Impact Investing

2.1. The evolution of Islamic Finance.

Islam is not only limited to religious beliefs and rituals because it is described as a (comprehensive) way of life, including involvement in economic activities. In comparison to the traditional financial system, the Islamic financial system does not differ significantly in the services and products. However, in essence, the operations in the Islamic financial system are built on a particular set of ethical and moral principles.

These determine what is viewed as morally 'right,' implying transactions and actions that promote the public good, meaning promotion of social welfare and financial inclusion. There are three Islamic finance principles: universal complementarity, justice, equity in al-hisba (accountability), and the abolition of riba (interest-bearing loans). Another feature of Islamic finance is that it prohibits payments or receipts of predetermined, guaranteed interest rate.

This stance does not leave the door open to the concept of interest and prevents the use of a western-style debt-based instrument.

Basically, if the money is in the bank or is not utilized in business, then money cannot increase (Wahyudi, Rosmanita, Prasetyo, Putri, 2015). Islamic finance encourages risk-sharing, promotes entrepreneurship, discourages speculative behavior, and emphasizes the sanctity of contracts by being grounded in physical assets. The development of modern Islamic finance can be divided into three periods, namely the experimental period, amorphous, and the metamorphosis period (Haniffa & Hudaib, 2010)

First period, 1940 to mid - 1970s is named as the experimental period. The initial thought of modern Islamic finance may be ascribed to Indian Muslims in the 1940s, in particular to Abul Ala Mawdudi, known as the founder of Jamaat-i-Islami and for writing the book Al-riba, who pressed for behavioral norms grounded on Islamic traditions (Warde, 2010). Authors like Quraishi and Sayyid Qutb expressed their dissatisfaction with the western-style economic and banking system, which was largely based on interest. This prompted Muslim economists and political Islamists to focus their attention on developing economic activities that are more compatible with Islamic shari'ah or religious law in Islamic tradition.

The second period from the Mid-1970s to 1990, is known as the amorphous period. Islamic finance entered a new phase in its history in the mid-1970s, as an outcome of two political-economic events: pan-Islamism and changes in oil prices in the Arabian Gulf States (Warde, 2010). The idea of Islamic banking was appealing to all interested parties, even for the developed world.

The major turning point was the fatwa in 1989 by the Grand Mufti of Al-Azhar, Sheikh Tantawi, who legitimized interest by allowing for new pragmatism on the explanation of riba the same way as interest (Mallat, 1996). This fatwa provided Islamic bankers with increased bargaining power enabling them to expand globally. To put it shortly, the amorphous period started with real sacred intentions by individual Islamic bankers who envisioned a banking system that acts in accordance with the goals and principles of shari'ah.

The metamorphosis period (1991-present).

The "New World Order," sparked by the fall of the Berlin Wall, dissolution of the USSR, wars in Yugoslavia and the formation of the Coalition of the Willing, which liberated Kuwait from the Iraqi occupation, marked the beginning of the globalization era and the emergence of new global norms, rules, and institutions (Henry & Springborg, 2001). Islamic finance was allowed to grow by most governments as it is a less costly and less risky option to appease the demands of their societies (Warde, 2010). Islamic finance had to go through a process of transformation so that it can be accepted or considered as a part of the global finance community. In the process, the genuine sacred intentions to fulfill religious responsibilities and acting as a piece of the worship became puzzled with the secular objectives of modernity. Describing the Islamic financial system simply as "interest-free" does not provide a correct picture of the system as a whole and tends to create confusion.

Even though forbidding the receipt and payment of interest rate is at the center of the system, the Islamic financial system is supported by other principles of Islamic teachings advocating individuals' rights and duties, such as the fair distribution of wealth, property rights, risk-sharing, the realization of obligations and the sanctity of contracts.

2.2 The evolution of Impact Investing, as known today, was created by the Rockefeller Foundation. At the time, this concept was so novel, that investors had never thought of other things as solely aiming for financial return. Today it is widely accepted that with investing as well as intentions for a positive impact on the society.

However, the roots of this concept can be traced back to John Wesley, the founder of the Methodist Church. He called for socially responsible investing in his Social Principles, which claimed that companies should take care of the workers, suppliers, and communities they work. Three centuries after Wesley, it is evident that today's world problems are more complex, more interconnected, and therefore new solutions are necessary.

Formally, impact investments were defined by GIIN (Global Impact Investing Network) as "investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return." (GIIN,https://thegiin.org/impact-investing/).

Impact investing has two essential elements: measurement of financial returns and intentionality that can be measured by the positive social impact the investment has. This return was for both, the impact investor and the impact investee benefit. Then, the United Nations paved the way and made it easier for impact investors when it introduced the SDG goals that humanity should strive to reach by 2030.

Thus, today's impact investing has become more and more mainstream for investors that align their investment decisions according to their intentions which are based on their values and ethics.

3. The main terminology of Islamic Finance and the connection to sustainable finance and SDGs

By the beginning of 2014, the total assets of Islamic investing was over $2 trillion globally, mostly reserved in Islamic banks or conventional banks that have an Islamic window (UNDP, 2014).

The Islamic financial system does not apply only to banking, as it covers the capital formation, financial intermediation, insurance, capital markets, and holds the view that along with controls, moral and ethical principles in the regulatory framework are also essential and necessary. Islamic finance may narrowly be described as a structure of ethical investing or lending, with the exception that there are no loans unless they are interest-free. The common feature within these products is based on risk-sharing. On the other hand, Sustainable Development Goals represent a broader intergovernmental agreement to foster action on broad-based development encompassing economic development, human development, and environmental sustainability.

3.1 The Connection between Islamic Finance and Sustainable Business

Firstly, Islamic finance tackles the problems that are addressed under the concepts of SRI and ESG integration. Human beings hold the responsibility of maintaining the well-being of the environment because they are commissioned as the stewards (khulafa) of God on Earth.

Secondly, within Islamic finance, there is a social responsibility to effectively and efficiently mobilize resources for the benefit of the community.

Thirdly, both the world of Islamic financing and the world of impact investing are both initiatives based on values and planned Intent (UNDP, 2014). One cannot point at values in the Qur'an. Baligh (1998,p.42) states however, that values can be inferred because the Qur'an contains "rules and from these, you know what values are." Qur'an demands the natural equilibrium and balance of the ecosystem to be maintained and protected for a sustainable world. Hence, Islamic finance has the potential to have a vital role in assisting the implementation of the Sustainable Development Goals (SDGs).

With regard to significant financial requirements for the SDGs, Islamic finance and its instruments have untapped potential as a substantial and non-traditional source of financing for the SDGs.

3.2 Islamic and Christian values

Faith-based investing is an important topic to discuss because religions can have a significant impact on how investors decide to invest; what they promote, and what they prohibit. Surely, there is no one size fits all when it comes to religions. However, there are apparent differences between Christian beliefs and Islamic beliefs.

For instance, the concept of 'positive screening' refers to the situation when investors decide to invest in companies whose work is consistent with their beliefs. Its opposite is 'negative screening,' where depending on investors' beliefs, they screen the market, the companies, and decide not to invest in industries, such as alcoholic beverages, pornography, tobacco, or gambling. In Christianity, the Calvinist or Puritan work ethic teaches that one must work hard, be frugal, save as much as he can, reject sinful activities, and invest in the future.

One of the institutions that guide investments consistent with the Church's beliefs is The Church of England, guided through their Ethical Investment Advisory Group (EIAG). In their guideline, they talk about being part of the UK stewardship code, which pushes investors to be good stewards of their investments. They also specify that they do not invest in companies who have more than 10% of their revenues coming from: conventional weapons, gambling, non-military firearms, human embryonic cloning, high-interest-rate lending, in companies that exceed 3% of the revenues from pornography. They also do not invest in companies who have greater than 5% of their revenues coming from alcoholic drinks unless the EIAG standards for responsible marketing are met.

Furthermore, their climate change policy also included that they do not invest in companies that derive more than 10% of their revenues from thermal coal or tar sands. (Church of England Ethical Investment Advisory Group Statement of Ethical Investment Policy, 2017) Another institution, Guidetone, does not invest in companies that are "publicly recognized as being incompatible with the moral and ethical posture of GuideStone Financial Resources." Guidestone, New Covenant Funds, The Interfaith Center on Corporate Responsibility, Christian Super, Timothy Plan Funds are examples of other faith based funds. There are also other Christian Mutual funds, where one the most well known is Ave Maria Mutual Funds.

On the other side, Islamic work ethics is based on Al Qur'an and the Sunnah, that includes values, belief and practice (Aslan 2015 as cited in Rafiki & Wahab, 2014). Avoidance of wealth accumulation, hard work, commitment, and dedication are among the behaviors that Muslims should engage in their day to day activities, and when doing business (Yousef, 2001 as cited in Rafiki & Wahab, 2014). In 2019 the global Islamic Finance had total assets between $2.5-3 trillion (Hill, 2020). In Islam, there are some industries where companies do not operate consistently with Islamic principles: alcohol, tobacco, guns, pornography, and gambling.
Also, collecting interest is considered exploitative, therefore, it is prohibited. Furthermore, when in a financing contract, profit and loss should be shared; in other words, partners all share either the risk or the return (Hill, 2020).

In order to satisfy the needs of Islamic value-based investors, indices that follow Shariah-based principles have been created. MSCI Islamic Index Series, MSCI World Islamic Index MSCI ACWI Islamic M-Series Index etc. Some mutual funds are: Aman Mutual Funds and The Iman Mutual Fund.

In terms of values, where Islamic values differ mostly with Christian ones is in the concept of intention. Intent within western Impact Investing is defined as planned intention. As a word ‘intention’ comes from Latin, and it can be translated as “to point at” and “to aim at”. Brentano talks about intentionality as mental states directed towards something (McIntyre & Smith, 1989). Husserl even considers intent as the “fundamental property of consciousness”. (McIntyre & Smith, 1989)

Within Islam, this definition has a lot more depth and meaning. Each Islamic virtue has 2 dimensions: the vertical dimension relates to God and the horizontal dimension relates to other people. Intent is such a virtue and it is central in Islam. The word intention (al-niyah) itself in Arabic comes from "Noy", where "alnoy" is the palm kernel (Farahidi, 1410, vol. 1, p. 238). Thus, just like the palm kernel is the seed of the palm fruit, the intention is in the heart. In other words, "niyya is the mental state of accompanying the act of worship, the intention that I perform this act" (Powers, 2015, pg. 73). He also held that intention also connected the mind and the action.

There are many sources in Islamic jurisprudence (fiqh) (but not limited to), which clearly state that Muslims are believed to be judged by their intentions and not the end result. The Prophet has said: "Verily, deeds are only by intentions. Verily, every person will have only what they intended. Whoever emigrated to get something in the world or to marry a woman, then his emigration is for whatever he emigrated for"[1]. He also said: "Verily, the people will be raised for judgment only according to their intentions"[4]. Apart from the Prophet's words, other Islamic scholars hold the same position.

For instance, Imam Sadiq stated that "The intention is superior to action." For Hor Ameli, intention is "the efficient cause that is formed in the human heart or mind and it is unseen and hidden in the human heart" (Hor Ameli quoted by Ahmad Faqih, 1996, p. 124). For Ghaffari, when with intention, one has the will, the decision to do something, but also the goal and objectiveness in himself (2016). Intention and sincerity in practicing the religion (deen) have a significant role.

Furthermore, unless the intentions are sincere, any act no matter how beneficial to the society, if done with the purpose of showoff, on the day of Resurrection, these deeds will be "scattered like dust". Another important term in Islam and closely related to intention is al-amanah. Al amanah in Arabic refers to honesty, but in Islamic carries several meanings which revolve around the idea of accountability; by being accountable, the fulfilment of trust is close to "al-amanah" (Badawi).

4. Islamic finance, Impact Investing in relation to Time horizon

4.1. The concept of time in Islam

The concept of time in Islam is central to Islamic philosophy, astronomy, theology and cosmology. However, the Holy Qur'an does not deal with the individual time because God creates people's destiny. Instead in Islam we see “a series of predetermined events binding divine omnipotence” (Böwering, 1997) Thus, God has predestined Just like in Democritus' atomism, as atoms and their clashes exist for a second, in the same way, God is creating the world constantly, continually, sometimes by intervening known as a 'miracle'. To Sufi mystics, time is like a parabola from infinity to infinity. Thus, God's time is eternal, whereas the human individual's time is only a dot that has no duration.

The vertical dimension is the theoretical side (an individual is dependent on God), while the horizontal dimension is the practical side, that includes believers just like atoms shaping their own ideas of time. (Böwering, 1997) From a different perspective, there is, on one side the predestination Al-Qadr (everything that will happen is already written much earlier than the individuals are born, and thus they live whatever is predestined) and on the other side, there is the free will in Islam. Free will is absolutely crucial in Islam. What connects these concepts is the idea of freedom. Humans are not only predestined with certain conditions, but they also can choose (free will).

For Muslims, the future is predetermined, yes, but their choices and their prayers can change these predestinations InshAllah. This concept In English can be translated as 'If God wills'. It is an essential concept in Islam that perhaps reflects a whole way of living since the idea is: "to me this option seems the best right now, but I do not know, God knows better than me, God's knowledge is limitless, but human knowledge of the future is limited. God already knows the future and what is expecting me ahead. Thus, if God wills this project will be completed". Usually, prayers (duaa) involve the concept of Khair too. Khair is anything good, benevolent, and beneficial.

So Muslims pray that God directs them to the right choice/option that has Khair and if it is God's voluntary (Inshallah). All these concepts are so closely related. If free will did not exist, then why would Paradise and Hell exist. If humans could not change their destiny by free will, then dua (prayer) would be useless, and punishing or rewarding people would make no sense because God already knew they would be Paradise inhabitants or Hell inhabitants. But since both predestination (Qadr) and free will exist, then choices are understandable, even if God already knows what the individual will choose. Humans as creatures differ from devils and angels, because of free will.

Angels had no choice and no free will. They were either inherently good or inherently bad, whereas humans can lift themselves to the angel level or fall to the devil level just by their choices. This is extremely important. Not only do humans have choices, but they also are free to choose. However, humans do not have absolute freedom. They come from different backgrounds: families, socio-economic statuses, and they have different talents. This, in essence, is predestination-qadar. Considering the concept of time: the past, the present, and the future, it can be concluded that the future in Islam can be shaped.

Even though it is already predestined (Al-Qadr) by God, but just as atoms, the individual can change it today, in the present through prayer (duaa), by the choices he makes (free will) so that he can align his or her deeds with what God wills (InshAllah). As it follows in the hadith:

"There is not one amongst you who has not been allotted his seat in Paradise or Hell. They said: Allah's messenger, then why should we perform good deeds, why not depend upon our destiny? Thereupon he said, no, do perform good deeds, for everyone is facilitated in that for which he has been created."

Sahih Muslim 2647

4.2. The concept of time in Impact Investing- Risk-sharing or risk transfer?

Logically, Islamic values and the Islamic understanding of time are reflected in Islamic finance. While conventional finance is based on risk transfer, Islamic finance is based on risk-sharing. The difference is significant. Conventional finance focuses on achieving returns on the short run, which in turn depletes the funds left to invest for more long-term financing. This short-term thinking has also caused other issues that we are dealing with today.

Today's western values, upon which is built conventional finance, hold that profit is the main focus of every business's main goal is profit. The authors believe that there is an untapped potential in long-term financing. This can be unlocked through sharing the systemic risk; thus allowing social projects to be launched. One of the ways that we can provide funds sustainably to long-term financing is through Islamic Finance. Islamic finance institutions lack rules and regulations destined for them but instead have developed financial instruments similar to conventional finance.

5. Conclusion-Risk sharing as a basis for a new model of innovation ecosystems?

The challenging goal of this article has so far been to connect Islamic finance with impact investing. We have discovered that there are many similarities between Islamic Finance and Impact Investing.

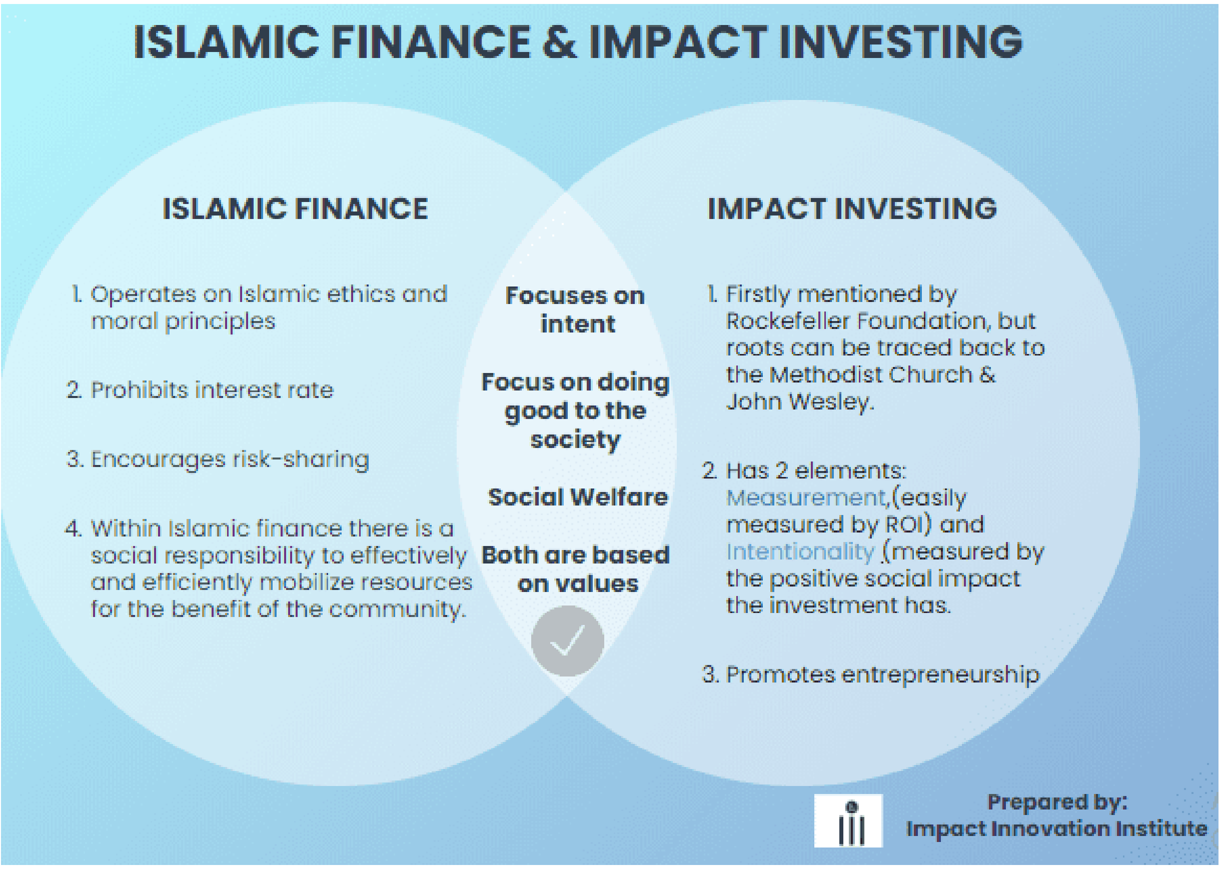

Figure 1: Islamic Finance & Impact Investing Venn Diagram. Source: Impact Innovation Institute, 2020.

However, through Islamic values, there is a clear definition for Intent, which is highlighting risk-sharing and social welfare. These values have a history since the beginning of

Islam, and as a consequence, they are deeply connected within Islamic societies. This deep connection is shown on these values' reflection in Islamic Finance instruments. One of these instruments are green bond sukuks, which are based on physical assets. Whereas, ithmar (seed financing) has a longer time horizon and an intent to make companies survive through risk sharing. Instead, impact investing has its roots within philanthropies born by Family Offices with a generational time horizon.

To note are the components of impact investing: the intentionality (the common denominator with Islamic Finance) and its measurement tool: financial return. Although there have been several initiatives in achieving SDG goals in the Middle East, due to the regional conflicts, there is still room for improvement. Sovereign Wealth Funds should aim for improved transparency in the process of doing good for society because it helps not only the society but also the sovereign fund themselves.

Surely, adopting transparency can have a ripple effect, and other sovereign wealth funds can be inspired in allocating their money in investments that have a positive impact on society.

The authors also believe that the risk sharing approaches advocated by Islamic finance and impact investing may be beneficial to understanding how to develop and scale innovation ecosystems. So far the prevalent concept for innovation has been the American one, consisting of VCs and angel investors seeding companies, growing them through subsequent funding rounds and finally the companies listing to the stock exchange. Islamic finance and the concept of risk sharing produce an alternative view, one which much like impact investing, places the definition of intent at the forefront of the innovation and investment processes. What kind of world do we wish to see emerge? Which are the values which guide our actions in the future? Who shall we align ourselves with to make sure we will be able to realize our vision for the future? These are questions impact investors and Islamic finance practitioners ask themselves on a daily basis. The concept of sharing risk with co-investors bares with it the notion of co-creating the world together. Other investors are not seeing as competitors fighting for the same deals, with only a handful few making the highest profits from individual deals. Rather, the future world of Islamic impact investing foresees a world where intention, values, culture and images of preferred futures which are shared with co-investors sharing the risk together with us, are the forces which enable more harmonious processes of innovation to emerge, enabling innovation to become a force of social good and harmony, instead of purely be seen as a process of disruption to the status quo.

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