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Islamic Venture Capitalism

Lessons to Learn from Social Venture Capitalism

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This article examines whether the ethical/moral claims of Islamic Finance should converge with the common principles of Impact Investing and Social Venture Capitalism to achieve *measurable* ethical outcomes. This article seeks to demonstrate a convergence between social venture capital and Islamic venture capital as both utilize equity investments and attempt to intentionally invest in ventures to seek a positive social outcome. Further research should explore how the Islamic Finance industry can address the lack of ethical *outcomes* in investments by implementing the rigorous measurement methodologies of investment currently utilized by impact investment, which has been incorporated into social venture capitalism.

Together, we can foster a 21st-century version of Islamic Finance that can deliver on all its promises. That is to promote financial inclusion and stability, meet the needs of financially underserved populations, lift potential growth, and create better opportunities for all people.

~ Christine Lagarde
former Managing Director of IMF
November 11, 2015, Kuwait City, Kuwait

Introduction

In a post-financial crisis era (2008 GFC), many conventional banks, economists, and depositors have been inspired by the moral and ethical foundations of Islamic Finance that seem to be absent from the traditional banking system.[1] However, in practice, the Islamic Finance industry is also facing a moral crisis.[2] The profit and loss sharing contracts of *musharakah* and *mudarabah* are less frequently utilized than debt-based contacts, and the outcomes of financing have been criticized for being less ethical than the "impact investing" movement within the conventional system.[3] This article will argue that the ethical/moral claims of Islamic Finance, based on the principles of interest-free lending and asset-backed investments into tangible economic activity, which are supplemented by a framework of Maqasid al Shar'iah (higher form of ethics), should converge with the common principles of Impact Investing and Social Venture Capitalism to achieve *measurable* ethical outcomes. In doing so, it will practice the theoretical ethical claims of Islamic Finance to deliver tangible benefits for investors and the larger society.

The Foundation of Islamic Finance

It is necessary to establish the basis of legal sources for Islamic Finance contracts which is an application of *Shari'ah*, literary meaning "the path." *Shari'ah* is derived from the two canonical texts of Islam, the Qur'an and the Sunnah, and is understood in a general religious sense to refer to Muslims' way of life. It covers both non-law and strict "law" matters. The former text, revealed to the Prophet Muhammad, is considered by Muslims to be God's immutable and infallible word. The latter is the example of the life of the Prophet Muhammad, which is now accessed through *hadith* literature. It is the compilation of the sayings of the Prophet Muhammad by his followers, then later collected and organized into six trustworthy (Sahih) books. Taken as a whole, *Shari'ah* encompasses a comprehensive cosmology that guides all aspects of human life with the understanding that humanity is interconnected with the Oneness of God (*tawhid*). Muslims understand that God created the universe, and every aspect of it reflects the unity of God, including the creation of humanity. Therefore, Islam and the *Shari'ah* do not admit to compartmentalizing knowledge and human life into separate unrelated spheres. Kamali explains that *tawhid* "manifests itself into ritual devotion and personal piety, in theology and law, in politics and economics, in faith and deeds, all of which are manifestations of the same all-pervasive principle."[4]

Another essential concept is *salihat* (good deeds). Hallaq argues that the core Islamic concept of *salihat* (good deeds) is integral to *iman* (belief) in Islam by

Muslims. *Salihat* (good deeds) is an overreaching divine message that when one does an act, whether it is a legal duty or social act, it must be done in an exemplary manner and with ethical, moral, and honorable conduct. Therefore, Hallaq states, "to speak kindly to people, to greet them, and to show them human compassion are attributes that have the same level of importance as those we call 'strictly legal' conduct."[5]

The Qur'an and the Sunnah provide legal injunctions and ethical conduct of those provisions of how one should conduct matters with fellow human beings, especially concerning commercial transactions. Professor Kamali explains that the laws of *Shari'ah* in the sphere of *mu'amalat*, which seek to regulate relations among individuals, constitute the primary concern of government authorities and the judiciary.[6] These are, in other words, justiciable, and the individual can seek judicial relief if his rights are violated by others or by the government.

The Principles of Islamic Finance

The most famous principle of Islamic Finance is the prohibition of usury or interest-based lending. However, more principles shape the Islamic Finance industry than just this. It is better to understand Islamic Finance as a system of legal principles, economic motivation (profit motive), and ethical guidelines. This is an important distinction, as simply focusing on the prohibition on interest overlooks how the principles of using an asset-backed currency and investing in tangible economic activity shape how the Islamic Finance industry functions.

Fiqh mu'amalat (commercial law) is a set of investment principles and prohibitions that consist of five prominent prohibitions.[7] They are the following: the prohibition of charging or paying of types of interest (*riba*), prohibitions on uncertainty (*gharar*), prohibition on gambling and speculation (*maisir*), the prohibition on certain banned commodities (*haram* goods), and the requirement of asset-backed investment into tangible economic activities. Beyond simply preventing the actions of Muslims, these prohibitions shape how Islamic contracts are structured.

The *Shari'ah* norm regarding commercial transactions and contracts is that actions are permissible unless a clear injunction stipulates the action is not permitted. The permissibility of Islamic commercial contracts is entirely a human endeavor, left to Islamic scholars, lawyers, and governments to tussle over what is and is not "Islamic." This process reveals the beauty of Islamic Finance. To make Islamic Finance work for people today, there is no need to reach a consensus among the differing opinions, as different communities have different needs. As such, it is an evolving process.[8]

Islamic equity-based financial products have developed on a profit and loss share basis to circumvent the problem of interest-based lending. The requirement to finance or invest using assets is equivalent to equity-based investment, similar to conventional venture capital models. These Islamic financial products are based on pre-existing contracts deemed suitable for financing. They can be mixed and matched however one pleases to achieve the necessary ends required for the venture. However, they simply cannot infringe on the prohibitions required by *Shari'ah*. Traditionally and in contemporary practice, the contracts of *musharakah* and *mudarabah* have been the most utilized for equity-based Islamic financing.

The equity-based contracts of *mudarabah* and *musharakah* can provide a basis to mirror the social and financial benefits of social venture capitalism. However, the application and utilization of these contracts are limited to the inspiration and structure of ventures that take place within a particular society. It has been argued that problems have arisen because of the restrictive and dichotomous ways these two instruments are used, causing the non-participatory nature of sharing profits, as agents remain in a sleeping partnership between being owners of capital who are not entrepreneurs and workers who provide effort in producing profits. The limitations in applying *mudarabah* and *musharakah* contracts have led Mufti Muhammad Taqi Usmani, arguably the most influential Islamic Finance scholar, to suggest that new forms of utilizing these contracts cannot be rejected because they have no previous precedent. He argues that every new contractual arrangement is acceptable by *Shari'ah* as it does not violate the legal prohibitions that *Shari'ah* states.[9]

Furthermore, when the Qur'an and hadith literature mention economic activity, there is a focus on cooperation and active participation to generate productive yields that bring about well-being in society. This is often called the higher objectives of the law (*Maqasid al-Shari'ah*). The tenth-century Islamic scholar Abu Hamid al-Ghazali wrote the defining characters of the higher objectives of the law:

> The very objective of the *Shari'ah* is to promote the well-being of the people, which lies in safeguarding their faith (*din*), their self (*nafs*), their intellect (*'aql*), their posterity (*nasl*), and their wealth (*mal*). Whatever ensures the safeguard of these five serves the public interest and is desirable, and whatever hurts them is against public interest and its removal is desirable.[10]

Incorporating the higher objectives of the law into the traditional *musharakah* and *mudarabah* financing models would move towards intentionally achieving moral outcomes for those investing, rather than merely satisfying the legal requirements of *Shari'ah*. Economist Masadul Alam Choudhury rightfully states that "the result would be a realization of both financial profitability in terms of the productivity of capital and its development in terms of increasing empowerment, entitlement, and ownership among partners including labor."[11] In an attempt to practice the principles of Islamic Finance and to achieve the higher forms of ethics of Islamic Finance, inspiration can be found in the impact investment and social venture capitalism space.

The Development of Impact Investments and Venture Capitalism

There is an existential need, even a requirement, within the Islamic polity to move beyond mere conjectures and debates over minute details of *Shari'ah* compliance and discuss the supposed heights of Islamic Civilization when a disproportionate number of the world population that lives under the poverty line is Muslim.[12] For this reason, this article explores applying Islamic Finance principles to achieve tangible economic development through the convergence of Islamic Venture Capitalism, social venture capitalism, and impact investing.

The Global Impact Investing Network (GIIN) defines impact investments as "investments made to generate positive, measurable social and environmental impact alongside a financial return."[13] With total assets exceeding $3 trillion, the impact investing industry has grown exponentially since emerging in the 1980s and presents a natural convergence with Islamic finance principles. An extension of impact investing is social venture capital, which takes the measurable social and environmental impact investing while utilizing equity investment funding to fund a for-profit social enterprise to achieve a profit while also delivering social impact. There is a natural convergence between Islamic venture capital structures and social venture capital. Both are financed through equity-based financing to achieve a positive social outcome; however, ethical inspiration comes from different sources.

Venture capitalism has become synonymous with the success of many high-tech companies in Silicon Valley, such as Google, Facebook, Oracle, and Sun Microsystems. Venture capital is equity or equity-linked investment in young, privately held companies, where the investor is a financial intermediary typically acting as a director, an advisor, or even a manager of the firm. In 2021, globally, venture capitalists had invested approximately $643 billion, primarily in high-technology industries.[14] In comparison to debt-based investments, venture-backed firms have a higher variance of earnings per share, lower levels of debt, higher research and development spending levels, and they achieve higher growth rates than non-venture-backed firms.[15] The purpose of venture capitalists is to maximize the return of their investment by gaining the most substantial profit from the operations of the business they have invested in. The entrepreneur benefits from having the venture capitalist use their industry knowledge and monitoring skills to finance projects with significant uncertainty.[16] Before moving into the specifics of how venture capitalism works, it is essential to understand that the roots of Silicon Valley and venture capitalism were founded with government investment in the early twentieth century.

Surprisingly, the roots of modern venture capital are found in American military investment rather than the "hippie culture" of the West Coast, as is often claimed.[17] The US government has been the largest Angel Investor in the research and development of military technology since the beginning of the twentieth century. It began with investment in the radio technology company Federal Telegraph Corporation based in Palo Alto, California, in the early 1900s.[18] The government contractors then collaborated with Stanford University's administration, forming the first partnerships between government investment, university research, and private corporations to create Stanford Research Park.[19] Before this, most military research was conducted on the East Coast and affiliated with Harvard University and the Massachusetts Institute of Technology (MIT).[20] The start of the First World War in 1914 led to the entire radio industry becoming nationalized in 1917 and furthered government research into this crucial industry. Historian of technology Stuart Leslie details how Silicon Valley owes its present configuration to patterns of federal spending, corporate strategies, industry-university relationships, and technological innovation shaped by the assumptions and priorities of Cold War defense policy.[21] The role of government funding in developing American venture capitalism is a variable that must be understood when comparing the development of venture capitalism in other countries, particularly Muslim-majority countries.

Funding Stages of Venture Capitalism

The modern form of venture capital funds and funding was shaped by the needs of young companies invested in high-tech industries that were seeking financing; however, they were too risky to qualify for traditional bank loans,[22] while usury laws limit the interest banks can charge on loans as the risk inherent in start-ups usually justify higher rates than allowed by law.[23] The venture capital model of financing is to release funds in stages to mitigate the problems arising from agency costs and asymmetrical information.[24] At the same time, the entrepreneur has the benefit of receiving funding from the venture capital fund with the incentive to develop the business successfully to receive further stages of funding.

The process of staging investments has a profound impact on facilitating the success of the investment and venture. There is no set requirement for how to stage investments or how many rounds of investment there should be; nonetheless, there is an industry standard. The first stage is known as early-stage financing; in this stage, the capital is used to conduct market research and product development. The second stage is seed capital funding, whereby the new funds are used to build a prototype and further the venture towards an official launch. The third stage is known as expansion financing, and here the venture is scaled up to help recruit more employees to establish engineering, sales, and marketing functions.[25] If the company seems successful at this point, the venture capitalists will help the venture go public through an Initial Public Offering (IPO). However, it has become more common for larger technology companies to acquire smaller firms through mergers and acquisitions.[26] Paul Gompers, the Eugene Holman Professor of Business Administration at Harvard Business School, has found evidence to indicate that the success of venture capitalism is due to staging capital infusions, allowing venture capitalists to gather information and monitor firms' progress and to maintain the option of periodically abandoning projects.[27]

By the venture capitalist having an equity stake in the company, they can be liable for losses in the investment, functioning as a profit and loss sharing mechanism. This provides an incentive to perform due diligence on the firm to ensure losses are not incurred, and high profits can be achieved. In contrast, debt contracts lead to conflicts of interest between the borrower and lender. Since the entrepreneur has to pay fixed payments regardless of the project's performance, the investment made by the lender has less incentive to ensure the successful execution of the business.[28]

An essential feature of venture capitalism is the process of staging investments. In a recent paper, Will Gornall and Ilya Strebulaev found that of all public US companies founded between 1979 and 2013, approximately 1,330 (43 percent) of them were venture capitalist backed. These companies comprise 57 percent of the market capitalization and 38 percent of the employees of all such "new" public companies. Furthermore, their R&D expenditure constitutes over 85 percent of the total R&D of newly public companies.[29] However, the emphasis of many venture capitalist-funded enterprises has been on maximizing growth without considering broader socioeconomic considerations.

Social Venture Capitalism

Social venture capital funds are attempting to fill this gap. Social venture capital is not entirely different from socially responsible investments, and both fit within the broader impact investing category. With total assets exceeding $3 trillion, the impact investing industry has grown exponentially since emerging onto the scene in the 1980s, which should inspire the Islamic Finance industry as a tangible means of applying Islamic principles and ethics into the marketplace.

Socially responsible investments are a similar phenomenon to social venture capitalism, whereby retail and institutional investors' conventional methods of investing incorporate social or moral criteria that must be adhered to while ensuring a return on the investments. In the 1960s and 1970s, socially responsible investors began to boycott investments in companies that were involved in the war in Vietnam or traded with apartheid-era South Africa.[30] The strategy of not investing in companies that fit particular criteria is known as "negative screening."[31] The movement for investors to implement positive screening techniques, actively searching out investment companies that the investor considers to be having a beneficial social or environmental impact, is known as "impact investing."[32] Socially responsible investments typically involve pension funds, mutual funds, and retail investors. They invest their funds into securities, whereas social venture capital takes the form of a venture capital fund and invests in small private companies to help them scale up and profit from the venture's growth. Again, both models are moving beyond the profit versus not-for-profit model and bridging the gap sought by investors.

The social venture capital movement began in the 1980s; it was led by investors seeking a link between their investments to social and moral *outcomes*. There is no set guideline or criteria for these social or moral outcomes. Instead, the prevailing trend is that social venture capital considers a social and moral outcome not considered within traditional venture capital investments, primarily focused on maximizing investor return and profit. However, the structure of social venture capitalism takes many notes from the traditional venture capitalists. This incorporation of values distinguishes social venture capital from not-for-profit organizations and philanthropy.

There are several similarities between social venture capitalist and the traditional venture capitalist. Social venture capitalists undertake extensive due diligence as they are liable for losses made in their investment (similar to the venture capitalist) while ensuring that investments meet their requirement of socially responsible investing. They also carefully monitor their investment and provide ongoing mentoring and support. Finally, the social venture capitalist carefully evaluates the possibility of growing the venture to address the broader social problems.[33] Social venture capital, socially responsible investments, and impact investments are all investment approaches that intentionally seek to create both financial return and positive social or environmental impact that is actively measured. From this perspective, there should be a natural convergence with Islamic venture capital.

Convergence between Islamic Venture Capitalism and Social Venture Capitalism

Moving beyond a mere legalist requirement of financial contracts being *Shari'ah*-compliant and attempting to fulfill the higher objectives of the law provides the potential for convergence with the broader impact investing movement and, specifically, social venture capitalism. The similarities between social venture capitalism and Islamic venture capitalism are that the purpose of the venture is to seek an ethical *outcome*. The broader impact investing industry, which social venture capitalism falls within, is much better developed at intentionally investing in socially responsible investments and measuring the outcomes of these investments. The International Finance Corporation estimate of the global market for impact investments shows that $2.3 trillion was being invested for impact in 2020, of which $636 billion have an impact management in place.[34]

The criticism regarding the lack of ethical outcomes in Islamic Finance can be addressed by implementing the rigorous measurement methodologies of investment currently utilized by impact investing. Therefore, it may be valuable for Islamic venture capital funds to use synergies with the impact investment model.

An obvious synergy between Islamic venture capital and social venture capital is that both are based on equity-based investments. The social venture capital funding model can be adapted to facilitate Islamic venture capital funding without reforming current Islamic finance regulations. However, the limitation of implementing a robust monitoring and measurement system falls on the jurisdiction that Islamic venture capitalism operates within. Al-Suwailem argues that "a successful venture capital market requires well-defined property rights, an effective legal system, positive social attitude towards sharing, as well as entrepreneurial activities, and an efficient mechanism for venture capitalists to cash out their investments, such as a functioning market for public securities and/or mergers and acquisitions."[35] Therefore, the potential for Islamic venture capital is to operate within the developed social venture capital markets of conventional finance to test the possibility of implementing these financial products in developing countries. This could provide a model for social venture capital in developing countries where Islamic Finance is predicted to grow more significantly than developed countries.

Utilizing Islamic venture capital in developing countries could also address the issue of corruption and moral hazards. Silvia Sagari, a researcher at the International Financial Corporation (IFC), criticizes the World Bank's practice of facilitating development by providing long-term loans. This model of financial development "has provided in practice fertile ground for the flourishing of moral hazard problems which jointly with inadequate follow-up have led to a poor performance from both a developmental and financial perspective."[36] Sagari prefers the venture capital model, in comparison to interest-based loans, as an attempt to solve some of the financial problems of the developing world. The intention to invest in profit-seeking enterprises that have a positive social outcome is one of the key similarities between social venture capitalism and Islamic venture capitalism.

The critical difference between Islamic venture capital and social venture capital is that the former has been based on pre-existing contractual structures that have limited the financial engineering of possible investments. The latter can focus on raising capital, monitoring and measuring investment to ensure an ethical outcome. As mentioned earlier, Usmani and Choudhury have criticized the limitations of solely using *musharakah* and *mudarabah* contracts. Both have advocated that there must be an effort to manifest ethical outcomes rather than simply ensuring *Shari'ah* compliance without manifesting positive social outcomes. Economist Mehmet Asutay argues that there has been a social failure in the modern Islamic Finance and banking movement. He explains, "[I]n the new institutional stage, Islamic banks should relate to the 'substance' and the 'consequence' rather than merely the 'form,' which would help to moderate and remedy the divergence observed in the present practice."[37] This particular problem has been addressed within the impact investment movement with further emphasis on quantifying the negative screens and the ethical outcomes.

Conclusion

The convergence between social venture capital and Islamic venture capital is that both are based on equity investments, and both attempt to intentionally invest in ventures to seek a positive social outcome. Although there are obvious synergies between these two forms of investments, the perception of Islam tends to be the factor that prevents the implementation of best practices from the impact investment industry to aid the Islamic Finance industry. There is an attempt to address this problem by re-labeling "Islamic Finance" as "Ethical Finance" for

Western markets. However, there is enough synergy between these two forms of investments that, if their substantive practice is explained, it may demonstrate to investors they are more similar than they are not. There has been some success in doing so, as Saturna Capital, based in Bellingham, Washington, has utilized its impact investment skills to include a *Shari'ah*-compliant fund. The Amana Mutual Fund is worth $3.5 billion. The concern of ethical investors to invest in socially responsible investments and to measure their positive social outcomes is a crucial step forward in measuring the positive social outcomes of an Islamic Finance industry still in its infancy.

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