Institutionalizing social impact investing: implications for Islamic finance

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Received 7 November 2017
Revised 18 June 2018
Accepted 27 July 2018

Abstract

Purpose – The purpose of this paper is to examine the institutionalization of screening and metrics in conventional finance and reflect upon the implications for Islamic finance.

Design/methodology/approach – The study involves the analysis of archival data, interviews and fieldwork with current impact investors in North America and the European Union to trace the historical development of impact investing screening and metrics.

Findings – First, the paper explores how conventional investors have applied positive and negative screens in the creation of their values/mission-based investment strategies. This is followed by a historical analysis of the development and implementation of impact metrics and regulatory frameworks that influenced the growth of conventional impact investing. The possible benefits of learning from these experiences for the Islamic finance industry are then considered. The paper concludes with an analysis of the potential value of mission/values-based investing for the economic development of the Middle East and North Africa region.

Research limitations/implications – Though not a comprehensive study of institutionalization, this study supports recent calls for more intentional use of capital for blended returns within Islamic markets. To support these initiatives, it provides scholars and practitioners with multiple recommended points of entry into this growing market.

Originality/value – There has been scant organizational research examining the development of best practices within the impact investment community and how these might be applied to other contexts such as Islamic finance.

Keywords Islamic finance, Impact investing, Institutions and institutional analysis

Paper type Research paper

Introduction

Blending the goals of private for-profit commercial ventures with those of philanthropic, non-governmental and state actors has been a growing trend within the investment community in the twenty-first century. Commonly known as impact investing within the finance literature, or social entrepreneurship in management (Olsen and Galimidi, 2009), participants in this space hope to create economic value for investors through both a positive financial return on their investment as well as social value by meeting a wide variety of other non-financial outcomes (e.g. poverty alleviation, economic growth and public-goods provision such as job creation, improved healthcare, etc.). In so doing, these pro-social actors hope to address challenges associated with institutional voids and diminishing natural resources while also earning a favorable monetary return (Duncan and Wong, 2010).

Nicholls (2007) argued there has been significant and continued demand for socially responsible investment within global markets. For example, private investment has outpaced individual government or multilateral development aid in the last 20 years

The authors of this paper have not made their research data set openly available. Any enquiries regarding the data set can be directed to the corresponding author.

International Journal of Social Economics

0306-8293
DOI 10.1108/IJSE-10-2017-0449

(Freirich and Fulton, 2009). To meet this growing demand, fund managers have developed ethical screens to assess the fit between available investment opportunities and the established values and mission of the funding organization. More recently, the increased visibility of social enterprises and the potential for impact investing have caught the attention of many governments, financial institutions, non-profit organizations and universities. The Aspen Network of Development Entrepreneurs has found that nearly 200 funds are currently involved in impact investing as of 2016. Furthermore, JP Morgan has estimated that impact investing could grow from US$400m in 2012 to US$2tn by the year 2020 (Saltuk and El Idrissi, 2014).

Despite the significant growth of impact investing in conventional financial markets, it remains notably underdeveloped within Sharia-compliant financial markets. In this paper, we define the conventional finance market as those organizations and processes that do not comply with Islamic rules governing economic transactions. In contrast, we define the Sharia-compliant market as those organizations and processes that comply with the obligations set out in Sharia law, including a prohibition on interest, pork, alcohol, pornography, gambling and weapons (El-Gamal, 2011). However, beyond compliance with these rules, the Maqasid-al-Sharia, i.e. the spirit, purpose and goals of the law, also implies the economy should provide for growth, justice and welfare for the whole community (Ahmed, 2011).

The difference between the growth of impact investing within conventional markets in comparison to Sharia-compliant markets is surprising given the ethical requirements of Sharia law and the principle that Muslims are accountable to the poor in society (Aziz and Mohamad, 2016). As very few impact projects in the Middle East and North Africa (MENA) region pass investors' initial financial requirements, the deployment of impact investment capital in the region has typically been quite low with current estimates at 2–5 percent of all social impact investments globally (Simon and Barmeier, 2010; Dash, 2017; Mudaliar *et al.*, 2018). The potential of aligning Islamic ethical values and societal needs has caught the attention of the Islamic Development Bank and the United Nations Development Programme, which announced the creation of the Global Islamic Finance and Impact Investing Platform in 2016.

Despite significant recent scholarly work comparing and contrasting conventional and Islamic finance (e.g. Sukmana and Kholid, 2012; Ashraf and Mohammad, 2014; Alexakis *et al.*, 2017), there are few examples such as the work of Bennett and Iqbal (2013) that call attention to the lessons these sectors can learn from one another. Moreover, recent publications on impact investing (e.g. Clark *et al.*, 2014; Morgan, 2017) pay little explicit attention to religious motivations or implications for how investments are designed. Considering the socially oriented religious mandates of Islam, and the significant potential of the MENA region and other Muslim societies to benefit from impact investing, this paper focuses on the lessons that might transfer from one context to another:

RQ1. How can the historical evolution of impact investing processes over the past 15 years be leveraged to accelerate the development of Sharia-compliant impact investing?

To answer this question, this paper analyzes the evolution and institutionalization of values/mission-based screens and impact metrics among conventional impact investors in order to identify best practices and potential points of convergence with Sharia-compliant investment strategies.

The present study

In order to investigate the historical evolution of impact investing screening and measurement, we conducted a thorough review of the industry since the year 2000. We complemented this review with insights on current practice through semi-structured interviews conducted with executives and fund managers in 15 organizations currently

involved in the conventional impact investing community[1]. Participants were selected first through a convenience sample of personal contacts followed by snowballing additional informants at relevant organizations. Selection criteria for interviewees included at least five years of direct experience in developing and implementing screening techniques and impact measurement. We employed a semi-structured interview protocol starting with questions about the participants' experiences with screening and measurement and then following their interests and opinions about future industry challenges and directions. This interview format may "provide better access to interviewees' views, interpretations of events, understandings, experiences and opinions" (Byrne, 2004). We interviewed until we reached saturation (Guest *et al.*, 2006). Finally, the data corpus includes fieldwork at impact investing industry events in Europe and North America from observing and participating in workshops, plenaries and networking events.

Using a theoretical lens grounded in institutional logic (Scott, 2008), the data set was coded to examine how screening and metrics development and the degree to which these processes have become standardized within the conventional investment community. The coding focused on an inductive thematic approach keeping with Silverman's (2001) guidelines to look for the how and then why, focusing on elements related to our principal question such as:

- the organization's definition of impact;
- history and use of positive and negative screening;
- development of impact measurements and any identified challenges;
- standardization of screens and metrics; and
- environmental pressures for convergence and standardization.

This approach goes beyond a simple enumeration of current screens and measurement elements by highlighting the historical development of screening methodology and non-financial impact measurement. Next, we explore the main themes that emerged from the compiled data corpus based on this coding scheme.

Conventional impact investing processes

After our analysis of the data, we propose a six-stage model for impact investing that has become institutionalized over the past decade. Derived from a standard process logic, this model incorporates both *ex ante* screening procedures into the decision-making process as well as *ex post* financial and non-financial measures to evaluate investment returns. Recent practices also incorporate an aspect of strategic or entrepreneurial goal adjustment/alignment that takes place after the assessment of value creation of the outputs. This model is shown in Figure 1.

As shown, the process begins with investors screening opportunities in accordance with their missions and providing the necessary inputs for social firms, e.g. capital, expertise, etc., who pass the screen as viable options. Having received resources, the organization then engages in its activities to create outputs that provide both economic and social value. Once the value of these outputs is assessed, firms and investors should engage in strategic adjustment/alignment to ensure that the process is meeting the initial goals and desired impact. Interestingly, in their case studies among social firms in Latin America, Ormiston and Seymour (2011) found that social enterprises had significant difficulty in measuring impact and then using that information to evaluate strategy. With this model in mind, we will now focus our attention on two specific parts of the impact investing process model where Islamic organizations could work toward complying with the Maqasid-al-Sharia, namely, screens and metrics.

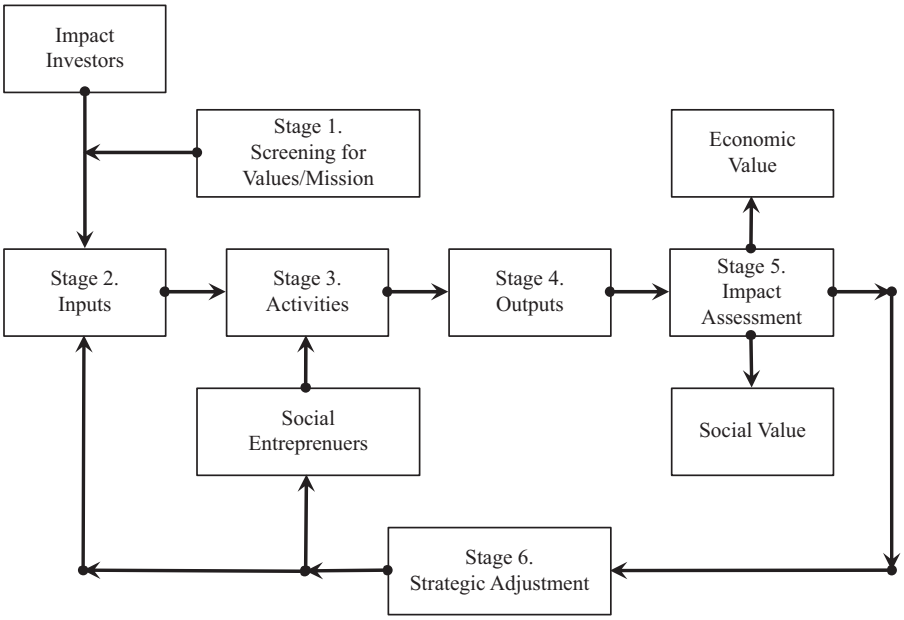

Figure 1.
Impact investing process model

Screening for fit

Investors in the impact investing space aspire to promote social development or tackle environmental issues within a set of values. Given the varied interests of investors (e.g. gender equality, healthcare improvement, poverty alleviation, sustainability, etc.), the incorporation of values into screens may take many forms. The main intent of screening is to ensure that investment decisions align with their interests, or at the very least, do not conflict with their values or mission. Impact investors employ both negative and positive screens when analyzing investment opportunities.

First, negative screens have been traditionally used by socially conscious investors when examining opportunities and are still commonly used throughout the industry (Viviers and Eccles, 2012). These screens are based on ethical guidelines that clearly establish certain industries or activities that are excluded from consideration. Alcohol, gambling, pornography, tobacco and weapons are examples of sectors that are always excluded by investors guided by religious considerations (Louche *et al.*, 2012). Critics of negative screens point out that while exclusion is a good first step in the process, this alone does not offer any guarantee that investments will lead to any sort of impact or social change. Moreover, negative screens are insufficient because investments may still flow to companies whose activities are morally objectionable (de Colle and York, 2008).

A growing number of organizations are now implementing positive screens. Positive screens include selection criteria to intentionally select opportunities that align with the funder's priorities (Michelson *et al.*, 2004). Depending on areas of interest, positive screens include guidelines for beneficiary selection, such as targeting the "bottom of the pyramid" or communities below a certain income threshold. They also target specific sectors where the community's needs are greatest such as women's health. For example, one fund manager we interviewed reported that the stage of development of potential firms has become an important consideration as their fund has decided to target young firms in the initial stages of development. Their logic is that these organizations have a more difficult time accessing capital in traditional financial markets without an established track record of success.