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**Article**

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# Venture waqf in a circular economy

Venture waqf

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## Abstract

**Purpose** – This paper aims to enhance the impact of incorporated waqf institutions by blending their resources to promote responsible small businesses that are inclusive of human development, service to society and preservation of ecological environment and other species. This is expected to shift the paradigm of businesses from the current waste-oriented linear economy to ideally a zero-waste circular economy.

**Design/methodology/approach** – This is an analytical study building on the experience of European Venture Philanthropy Organizations (VPOs) that work with the primary objective of making impactful businesses successful, with capital protection and return on investment being of secondary concern. This paper suggests an incorporated institutional design that blends resources for promoting responsible businesses using a new hybrid financial mechanism, namely, equity-at-default (EaD) to replace collateral and foreclosure requirements with responsibility and compassion.

**Findings** – The research calls for changing the business paradigm from linear to circular, an incorporated institutional framework for venture waqf, purpose of the waqf to make impactful small businesses successful and designing a financial contract to loan in favor of responsible businesses that convert to equity stake for the waqf in case of default (EaD) replacing collateral and foreclosure requirements.

**Research limitations/implications** – This is a theoretical study motivated by the success of VPOs but assigns a new role to waqf institutions. Furthermore, the incorporated nature of waqf is a new idea and EaD is a new mechanism. Being new, these ideas have the risk of not being implemented. However, the broader message that waqf shall promote businesses that are inclusive of ecological concerns is generally applicable.

**Practical implications** – The paper has a significant practical implication to transform the responsibility and consciousness of businesses. Waqf is fundamentally a compassionate institution, and it must enhance the responsibility of businesses to become more inclusive of the environment and other species. It should also become more compassionate toward businesses that are in distress and default. In this sense, the paper tries to internalize compassion in financial contracting that can potentially change the architecture of lending.

**Social implications** – Altering businesses' mindset from a waste-driven extractive linear economy to inclusive circular economy has a tremendous transformative role. This will have implications for enhancing business consciousness and responsibility. As poverty is a phenomenon of state of mind, changing the society's state of thought in Muslim communities is expected to have basic positive implications. Entrepreneurs with a new mindset can have far-reaching positive impacts on the society.

**Originality/value** – The paper offers potentially innovative perspectives in four key areas and blends the different resources in an incorporated waqf that makes responsible entrepreneurs assume a partnership role in times of distress through EaD. Furthermore, the integration of compassion in financial contracting could have better implications for return on investment as well. The ideal state of an economy is where waste is turned into wealth and well-being is something that all policymakers must keep on the top of their agendas.

**Keywords** Waqf, Circular economy, Venture philanthropy, Zero-waste economy, Equity-at-default

**Paper type** Research paper

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## Introduction

Waqf is an endowment for a good purpose and is sanctioned by the Sharī'ah (Islamic law). It has played a pivotal role in Islamic civilization and Muslim societies as recorded in the voluminous historical literature. Over the past three decades, a vast contemporary intellectual effort has emerged, and significant policy-driven institutional efforts have been made all over the world to reinvigorate this important institution of the Islamic economy. There are numerous practical initiatives ongoing worldwide to harness the power of waqf for multidimensional human development. In different jurisdictions, these initiatives are registered under waqf, endowment, trust, or charity laws. In a recently released joint study by [Bank Indonesia \(BI\)](#), [Indonesian Waqf Board \(BWI\)](#) and [Islamic Research and Training Institute \(IRTI\)-Islamic Development Bank \(IsDB\)](#) (2018), Jeddah, the challenges, principles, and rules of good governance of waqf are set. It is understood from these guidelines that waqf can be established by a God-fearing Muslim philanthropist for any good purpose that can please Him. This, in the author's view, includes the new purpose of waqf that is focused on in this paper, namely, to make impactful businesses successful.

There could be different modalities for establishing a waqf. Under the most prevalent model, waqf institutions mobilize waqf funds and pool these funds to establish Sharī'ah-compliant businesses and investments. The income proceeds of the businesses and investments are used for providing emergency aid, food, health, educational and other assistance to the underprivileged segments of the society and for community empowerment ([Alam, 2010](#)), among numerous other studies). Waqf initiatives address the alleviation of economic poverty, which is a purpose of high merit.

Indeed the businesses in which these waqf funds are invested must be Sharī'ah compliant and hence must intrinsically contain social responsibility considerations. However, none of these practical efforts of organizations and none of the vast literature dealing with the revival of waqf have the primary purpose of making these socially responsible small and micro businesses successful.

Therefore, a number of pertinent concerns arise:

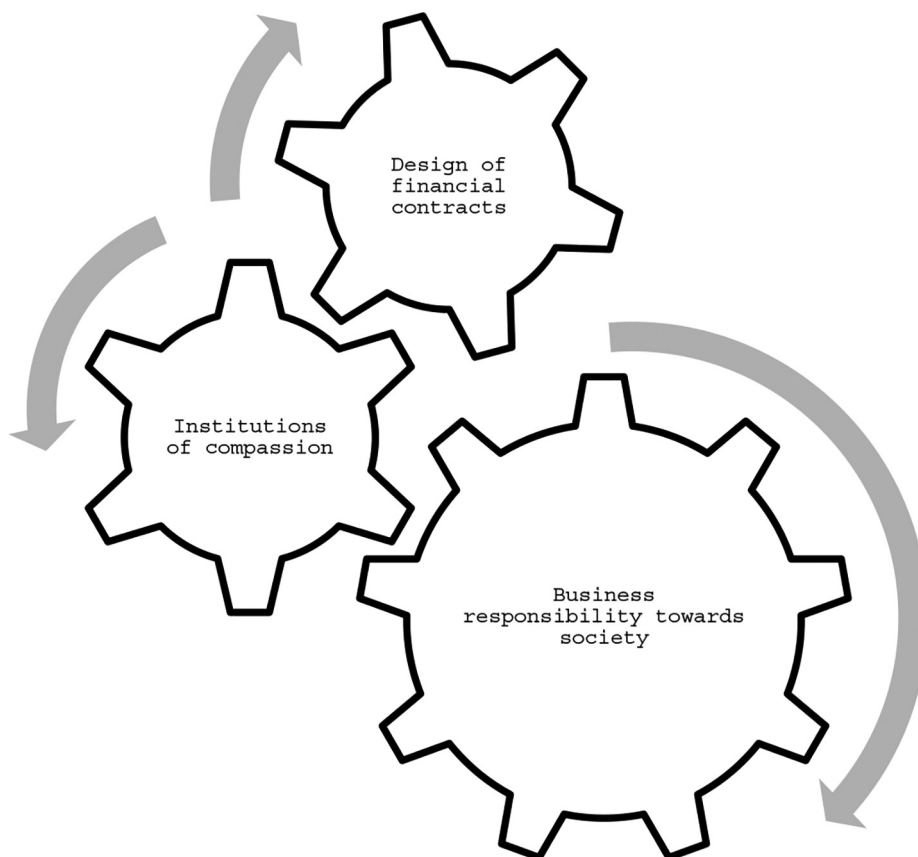
- Is poverty a phenomenon of material resources, or is it the cause of a typical mindset? This paper is based on the understanding that the root cause of social inequalities is actually the negative externality of poverty of consciousness. Two important examples are elaborated – first dealing with the conscious responsibility of businesses and second dealing with the conscious design of financial contracts.

First, it is to be highlighted that businesses may either be reckless or responsible towards the society, ecology, and species, generating either positive or negative externalities. A pertinent example of negative externalities is the rampant behavior of dumping waste into landfills, rivers, and seas, burning wastes and spewing toxins into the environment. Usage of bags and other plastic products that damage the environment is another example. On the other hand, businesses could be conscious of being impactful through positive externalities. One effective example could be a zero-waste business strategy. It means that a compassionate institution such as waqf can make this as a purpose to maximize the positive externalities of businesses.

Second, the design of financial contracts is important in conjunction with the above-mentioned positive or negative business mindset. In the Islamic economy, the original intent of the following contracts, and others, is that they are compassionate in nature: *kafālah* (sponsorship), *wakālah* (delegated authority), *ḍamān* (guarantee), *takāful* (Islamic insurance but originally mutual protection), *tawarruq* (tripartite sale, but originally a bilateral lending by mutual sale and purchase), *ḥawālat al-dayn*

(transfer of debt) and *qard* (interest-free loan). However, in view of practical urgencies, these have been commercialized. It means that a compassionate institution such as waqf has an important potential role of effectively using these listed instruments of compassion to harness their social power.

Another important aspect of the design of a financial contract is related to safeguarding the rights of the contracting parties as prescribed in the contract covenants. Collateral secures the lender's rights at the beginning, and foreclosure secures the lender's rights at termination in the case of distress. The borrower's rights are not commercially recognized, although in Islamic finance under compassionate considerations, the borrower is legally and morally protected with forbearance. Therefore, there are at least three vital concerns as summarized in [Figure 1](#), namely, the purpose of business, institutions of compassion, and design of contracts. A compassionate institution such as waqf is expected to play a role where compassion can be internalized in financial contracting. An analogy of this expectation can be found in the expectations of family and neighbors when a person gets sick; they get



**Figure 1.**  
Institutions of  
compassion, design of  
contracts and  
business  
responsibility

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closer in warmth, sympathy, encouragement, and delivering help. In the same spirit, when a responsible business gets sick, a compassionate institution such as waqf is expected to get closer, exercising forbearance and potentially taking more responsibility as a partner in overcoming the distress instead of invoking foreclosure and closing the distressed business.

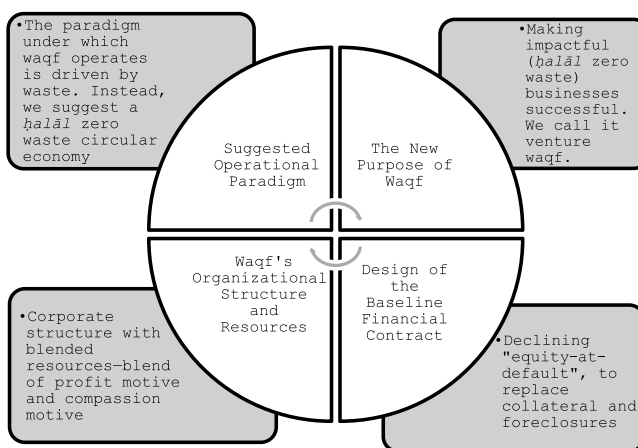
- Is it not a fact that collateral and foreclosures are inevitable in financial contracting and that it is impossible to avoid them? Indeed collateral is the essential initial pillar, and a foreclosure is the inevitable ending pillar of the existing commercial loan-driven financial architecture. Owing to these two foundational requirements, greed is inherent in financial contracting, and compassion remains an external idealistic phenomenon. Hence, collateral and foreclosure are barriers to accessing financial services by small and micro-enterprises. With a built-in compassion mechanism, declining equity participation has the potential power to replace both collateral and foreclosure requirements. To further embed and blend compassion in financial contracting, the baseline contract is suggested as an interest-free loan with a blended option to convert into declining equity at the trigger of a default event. With the Islamic ideals of compassion in place, the healthy people of the family and community take care of the sick person. With the compassionate spirit, the designated waqf is expected to take care of the sick and defaulting responsible small businesses by taking an equity stake instead of foreclosure.
- Can the primary purpose of a waqf be the ultimate success of an impactful small and micro business? It is argued that as the rescue of a person from sickness can be the legitimate purpose of a waqf, the rescue of a responsible business from sickness can also be the sole purpose of a waqf, provided the business is Shari'ah-compliant and impactful. Venture waqf (VW) is a proposed institution for the specific purpose of making Shari'ah-compliant impactful small and micro businesses successful. The vision of the VW institution is to support and make successful small businesses that apply the Islamic vision of entrepreneurship for achieving a zero-waste free market economy. The mission of the VW institution is to internalize the motivation of compassion in the profit motive, to raise funds for the vision, and to channel the funds to selected impactful small businesses using different Islamic financial contracts.
- Is it possible to blend the different resources of a waqf institution? The existing waqf institutions collect their financial resources as waqf contributions. It is argued that the waqf institution established with the purpose of making impactful businesses successful could blend its resources. The sources of funds and other resources of the VW could be interest-free loans; charitable grants; waqf contributions; investments; structured and blended financing with philanthropic organizations; voluntary service and advice; compassionate guarantees; and any other legitimate contributions.
- Is it possible for the waqf to act as a venture financier or investor? Venture finance or investment must have a predetermined exit strategy. The nature of the proposed VW is such that it must make impactful businesses successful and must exit so that it can support other new businesses. The VW will use the funds and other non-pecuniary resources such as voluntary advisory and training services, voluntary guarantees and other resources for financing, training, capacity building, business advisory, and incubation, accessing markets, subsidizing finance, insurance and guarantees, and research and innovation.
- When there are abject economic poverty and other urgent needs, how can VW be justified for the above-mentioned purpose? Abject economic poverty and other social inequalities and rising concerns with environmental imbalances are the

results of the waste-oriented existing capitalistic economic system. As a root-cause treatment, compassion needs to be blended with the profit motive along with a zero-waste entrepreneurial philosophy. The purpose of the VW is to achieve a working model of such a compassionate free market economy. Waqf already deals with Shari'ah-compliant businesses, and VW only formalizes compassion in the business model through the design of the financial contract and through the requirements of conscious responsibility of the business.

Given the above explanations and observations, the purpose of the paper is summarized and recapitulated in Figure 2. In this paper, it is suggested to:

- replace the current waste-driven linear economy paradigm with a new zero-waste *halal* (Islamically permissible) circular economy paradigm consistent with the Islamic vision of entrepreneurship;
- establish waqf as a corporate entity, looking at the experience of the European Venture Philanthropy Organizations (VPOs);
- assign a new purpose to waqf as venture-waqf (VW), to make impactful (zero waste *halal*) small businesses successful and then exit; and
- use a new baseline compassionate financial contract – an interest-free loan with a built-in condition that in the case of default, the defaulted amount will become the equity of the VW on a declining partnership basis. This is to replace collateral and foreclosure requirements of the existing interest-based lending instruments.

The remainder of the paper is structured as follows. After having provided a background on the paper and delineating its objective in the introduction, in the next section, the basic Islamic premises of entrepreneurship are elaborated. In the following section, the Qur'anic mentioning of ecology in the context of the universe is referred to, and inferences are drawn from them. An economic paradigm is then deduced from what has been discussed, and basic parameters for multidimensional development are set. Afterwards, it is argued that poverty is a



Source: Author's own

**Figure 2.** Integrated summary of the purpose of the venture waqf in circular economy

state of mind and that we need to get rid of it by recognition, determination, an enterprising mindset, and focused action. The institutional framework that is required for a transition from the current linear economic paradigm driven by waste and greed to the more compassionate circular economy paradigm is discussed. The last section concludes the discussion.

### The Islamic vision of entrepreneurship and the ideals of zero-waste economies

This paper is based on our understanding of the existence of two competing paradigms about human motivation and behaviour as evident from several Qur'ānic verses:

مَنْ كَانَ يَرِيدُ حَرْثَ الْآخِرَةِ نَزِدْ لَهُ فِي حَرْثِهِ وَمَنْ كَانَ يَرِيدُ حَرْثَ الدُّنْيَا نُؤْتِهِ مِنْهَا وَمَا لَهُ فِي الْآخِرَةِ مِنْ نَصِيبٍ

Whoever desires the harvest of the Hereafter-We increase for him in his harvest. And whoever desires the harvest of this world-We give him thereof, but there is not for him in the Hereafter any share (Qur'ān, 42:20).

In the first paradigm, absolute material considerations drive human behaviour. In this paradigm, wasteful instincts drive the attitudes of entrepreneurs, individuals, households, and firms. The Qur'ān equates such attitudes with the fellowship of the devil:

إِنَّ الْمُبَذِّرِينَ كَانُوا إِخْوَانَ الشَّيَاطِينِ وَكَانَ الشَّيْطَانُ لِرَبِّهِ كَفُورًا

Those who squander are the brothers of Satan, and Satan is most ungrateful to his Lord (Qur'ān, 17:27).

In the second paradigm, our consciousness is driven by a balance and harmony between the worldly good (the for-profit motivations of life); and what is best in the Hereafter (the not-for-profit motivations of life). This is clear from the following verse from Surah Al-Baqarah:

رَبَّنَا آتِنَا فِي الدُّنْيَا حَسَنَةً وَفِي الْآخِرَةِ حَسَنَةً وَقِنَا عَذَابَ النَّارِ

Our Lord, give us good in this world and good in the Hereafter and save us from the torment of the Fire (Qur'ān, 2:201).

The Islamic vision of entrepreneurship falls within the second paradigm. It has a direct manifestation of being honest (*amīn*), trustworthy (*sādiq*), imbued with compassion (*rahmah*), and establishing balance (*mizān*), which includes environmental concerns. These are the requirements of the second paradigm. As an entrepreneur, Prophet Muḥammad (peace be upon him) practiced these character traits even prior to the commencement of his prophethood. Aversion to waste is an important attribute of conscious behaviour of entrepreneurs, individuals, households, and firms.

In our times, the first paradigm is represented by the linear global free-market economy, which has resulted in social inequalities and environmental imbalance. Ecological, social, and compassionate concerns are external to the paradigm. With respect to the importance of sustainable small businesses, despite considerable growth and the spread of microfinance globally, the results are not satisfactory, nor do they inspire much hope. The paradigm has also greatly influenced Islamic economics and finance. Through legal stratagems, several instruments of compassion became part of commercial activities. *Kafālah*, *ḍaman*, *tawarruq*, *wa'd*, and *hawālat al-dayn* are only a few of the numerous examples that were originally compassionate but have gradually been turned into commercial activities. In such a paradigmatic framework, service to society on the one hand and financial return, on the other hand, become competing and conflicting goals, and precedence is always given to the latter.



**Ecological balance (*mīzān*)**

The Qur’ān has numerous references to the balance in the creation of the universe and its living species and the life-sustaining qualities of water, air, and energy. It further points out the calamities and disasters that occur because of irresponsible human behaviour:

وَالْأَرْضَ مَدَدْنَاهَا وَأَلْقَيْنَا فِيهَا رَوَاسِيَ وَأَنْبَتْنَا فِيهَا مِنْ كُلِّ شَيْءٍ مَوْزُونٍ

And the earth-We have spread it and cast therein firmly set mountains and caused to grow therein [something] of every well-balanced thing (Qur’ān, 15:19).

وَجَعَلْنَا لَكُمْ فِيهَا مَعَايِشَ وَمَنْ لَسْتُمْ لَهُ بِرَازِقِينَ

We provided sustenance in it for you and for all those for whom you do not provide (Qur’ān, 15:20).

وَالسَّمَاءَ رَفَعَهَا وَوَضَعَ الْمِيزَانَ

He has raised up the sky and set the balance (Qur’ān, 55:7).

أَلَّا تَطْغَوْا فِي الْمِيزَانَ

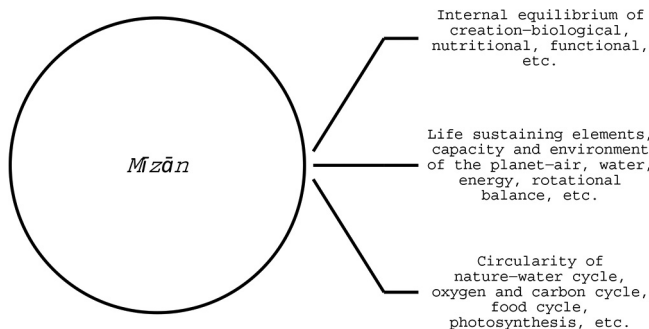
[. . .] That you not transgress in the balance (Qur’ān, 55:8).

Building on these and other verses [Akhtar \(1996\)](#) and [Kamali \(2010\)](#), among others, emphasize that Islam establishes environmental balance (*mīzān*). [Al-Mubarak and Goud \(2018\)](#) formulated and summarized these meanings of environmental balance, which we have rendered in [Figure 3](#).

**Searching for a compassionate paradigm**

Ecology, as it appears in the Qur’ān, is referred to in the previous section. This section deduces an economic paradigm from the previous sections.

Science and technology have made tremendous progress by following natural laws in what is known as “biomimicry” to behave exactly as nature works. If we observe nature with respect to resources – water cycle, oxygen cycle, carbon cycle, photosynthesis, food cycle, etc. – we will come to the conclusion that *nature does not waste*. However, the existing



Source: Idea credit: Al-Mubarak and Goud (2018)

**Figure 3.**  
Summary of interpretations of verses about environmental balance

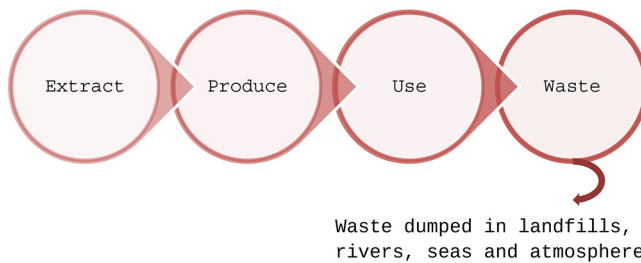


dominant economic paradigm is linear (Figure 4) – extract resources, produce, use, and waste. Waste is an essential ingredient of the paradigm, and businesses operate within this dominant extractive and greed-driven system.

Following the consistent relationship and harmony between science and nature, economics can also learn from nature. As *nature does not waste*, economics too can adopt a zero-waste paradigm. If we observe nature, for example, the water cycle or food cycle, we notice that zero-waste is achieved by nature by a circular system. In the same manner, through a circular instead of the linear economic system, we can achieve zero-waste, compassionate, and inclusive economies.

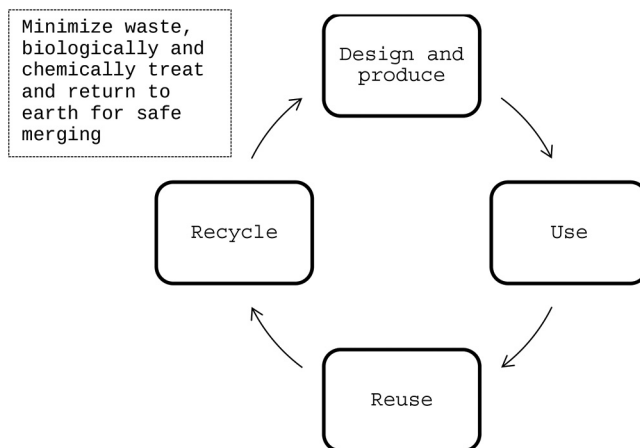
Figures 5 and 6 summarize the circular economy paradigm and potential steps to reach a zero waste level. The circular economy literature (Lacy and Rutqvist, 2015) identifies a number of waste reduction opportunities, including the following:

- behavioral rationalization of consumption to eliminate wastage of food, water, energy, clothing, wealth, etc.;
- enhancing design, repair and maintenance to eliminate wastage in product life cycles;



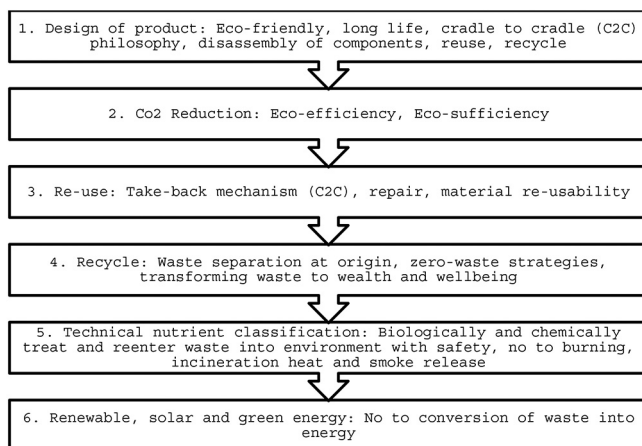
**Figure 4.**  
Linear economy  
paradigm

Source: Author's own



**Figure 5.**  
Paradigm of circular  
economy

Source: Author's own



**Source:** Drawn by author from literature

**Figure 6.**  
Steps to achieving  
zero waste

- promoting sharing and uberization to eliminate wastage of useful capacity of assets;
- cradle-to-cradle (C2C) philosophy to eliminate wastage of material value of waste;
- implementing recycling to eliminate wastage of the value embedded in waste;
- promoting usage of solar and renewable energy to eliminate wastage of potential resource;
- incentivizing eco-efficiency and eco-sufficiency to avoid wastage of energy utilization opportunities; and
- chemical and biological treatment of waste for remerging with the environment to avoid wastage of beneficial components, avoid incineration, and smoke and heat release.

Waqf is a compassionate organization, and its spirit and ethos are consistent with the more compassionate and inclusive circular paradigm. However, owing to the overwhelming dominance of the linear paradigm, the existing waqf organizations also work within the framework of the extractive paradigm as its *ḥalāl* (Islamically permissible) subset. Indeed for all practical purposes, Islamic finance and the *ḥalāl* economy, as well as Sharī'ah governance, also function as a *ḥalāl* subset of this extractive paradigm. The role of a new waqf is to relocate businesses in a more compassionate and inclusive zero-waste paradigm and ultimately transform economies to become more compassionate and inclusive.

In addition to waqf, there are a number of other institutions of compassion in the Islamic economy. These are:

- *Qarḍ*
- Forbearance
- *Ṣadaqah* (charity)
- *Hibah* (donation)
- *Kafālah*
- *Wakālah*
- *Ḍamān*

- *Takāful*
- *Hawālat al-dayn*
- *Wa'd* (promise)
- *Tawarruq*

Owing to the overwhelming dominance of the linear economy paradigm and the need for commercial competitiveness of the Islamic financial services such as waqf, all these institutions of compassion have also come under pressure. Several of these have already been commercialized. However, the immense power of these institutions of compassion is dormant, and this power could be harnessed within the new compassionate circular economy paradigm. Waqf can act as the umbrella framework for the revival of the compassionate power of these institutions.

Within the new and more compassionate circular economy paradigm, one of the relevant emerging examples is the institutional framework of Venture Philanthropy Organization (VPO). VPOs target making impactful businesses successful, profitability is the secondary objective. Data suggest that the motivation of over 75 per cent of VPO participants is actually the success of small and medium social impact businesses. (Please see [Figure 8](#) below.) The primary motivation is not capital protection or a financial return on investment.

### Poverty as a state of mind

Continuing on the previous sections, which have set basic parameters for multidimensional development, in this section, it is argued that poverty is a state of mind and that we need to get rid of it by recognition, determination, enterprising mindset, and focused action. However, the development of sustainable small businesses also requires multidimensional efforts by different stakeholders. Let us cite here a *ḥadīth* of Prophet Muhammad (peace be upon him) narrated by Anas ibn Mālik:

A man of the Ansar came to the Prophet (peace be upon him) and begged from Prophet (peace be upon him). He (the Prophet) asked: Have you nothing in your house? He replied: Yes, a piece of cloth, a part of which we wear and a part of which we spread (on the ground), and a wooden bowl from which we drink water. He (the Prophet) said: Bring them to me. The man then brought these articles to the Prophet (peace be upon him), who took them in his hands and asked: Who will buy these? A man said: I shall buy them for one dirham. He said twice or thrice: Who will offer more than one dirham? A man said: I shall buy them for two dirhams. He gave these to him and took the two dirhams and, giving them to the Ansari, said: Buy food with one of them and hand it to your family, and buy an axe and bring it to me. He then brought it to him. The Apostle of Allah (peace be upon him) fixed a handle on it with his own hands and said: Go, gather firewood and sell it, and do not let me see you for a fortnight. The man went away and gathered firewood and sold it. When he had earned ten dirhams, he came to him, having bought a garment with some of them and food with the others. The Prophet (peace be upon him) said, "This is better for you than begging, to come as a blemish on your face on the Day of Resurrection. Begging is appropriate only for three people: one in severe poverty, one in severe debt, and one who must pay difficult compensation. (Sunan Abu Dawud, *ḥadīth*, no. 1641).

It is obvious that we can draw a number of lessons from this episode:

- self-reliance is preferred, and dependency on welfare is discouraged;
- leadership and community have important roles to play;
- technical assistance, business advice, and follow-up are important to make the small business successful; and
- market and compassionate considerations of the community could and should be blended to make small businesses successful.

### Blending compassion and the profit motive

The previous sections outlined the parameters of a new economic paradigm based on compassion, avoiding waste and caring for the environment, future generations, and other species. This section discusses the institutional framework that is required for a transition from the current linear economic paradigm driven by waste and greed to the more compassionate circular economy paradigm.

The proposed institutional framework includes two interdependent components:

- (1) a new waqf institution – venture waqf organization (VWO) – with a new purpose to make impactful businesses successful; and
- (2) a new baseline financial contract – equity-at-default (EaD) – to replace collateral and foreclosure requirements.

#### *Venture waqf organization: harnessing the power of compassion*

Waqf is a compassionate organization by its intent and purpose. As listed above, the other institutions of compassion of the Islamic society are *qard*, forbearance, *ṣadaqah*, *hibah*, *kafālah*, *wakālah*, *ḍamān*, *takāful*, *ḥawālat al-dayn*, *wa'd*, *tawarruq*, etc. Some of these institutions have been trained to operate as commercial instruments. Their original compassionate intent is dormant but could be harnessed with the proper institutional arrangement. VWO is a proposed new incorporated entity with a legal personality that is envisioned to make responsible businesses successful. The VWO would ensure the achievement of this vision by:

- reorganizing and strengthening all the Islamic institutions of compassion listed above;
- financing through different Islamic instruments, especially a new instrument called EaD;
- capacity building, advising, coaching and mentoring;
- assuming a more controlling and enabling role in case of distress;
- blending profit with compassion; and
- playing a social venture role.

The resources of the VWO would be raised through interest-free loans, charitable grants, zakat contributions, waqf contributions, investments, structured and blended financing with philanthropic organizations, voluntary service and advice, compassionate guarantees, *takāful*, and any other legitimate Sharī'ah-compliant contributions. These resources would be utilized by the VWO for financing, training and capacity building, advising and information services, business incubation, accessing markets, subsidizing finance, and research and innovation.

#### *Lessons are drawn from motivations of venture philanthropy participants*

The suggested VWO idea draws on the institutional experience of the Venture Philanthropy Organization (VPO) as described by [Balbo et al. \(2016\)](#). Meanwhile, it is imperative for the venture-waqf (VW) to simultaneously meet the Sharī'ah requirements of financial contracts and with a focused target concerning the success of a zero-waste Sharī'ah-compliant business.

[Figure 7](#) summarizes the motivation of VPO fund providers, and [Figure 8](#) summarizes VPO funding sources. It can be seen that VPO participants give precedence to the success of

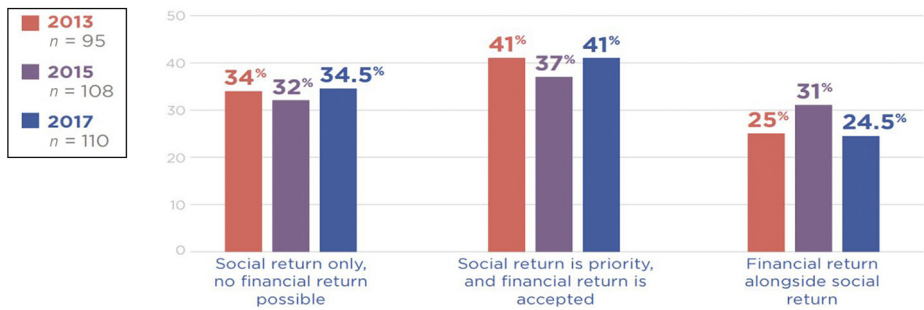
the social enterprise over financial returns. Based on this evidence, in the hierarchy, the first goal of the VW could also be the success of the high impact socially responsible enterprise; the second goal being capital protection, and the third goal return on investment.

*Equity-at-default: internalizing compassion in financial contracting*

A normal commercial loan contract has a collateral requirement at entry and a foreclosure condition in cases of borrower distress. Commercial loan architecture rests on these pillars. Small businesses find it impossible to provide adequate moveable collateral. Small businesses are also devastated when the contingency of invoking foreclosure becomes real. Hence collateral and foreclosure are critical barriers to small businesses accessing financial services.

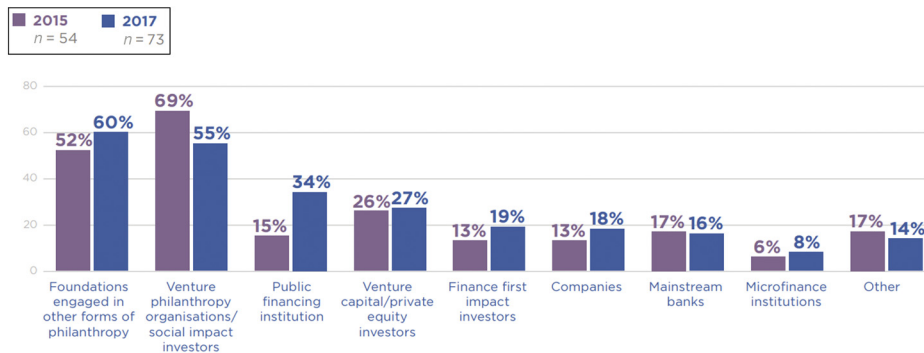
While financing small businesses, the VWO can use different Islamic financial contracts, including declining partnership. In what follows, the prospect of combining a loan contract with the declining partnership as an embedded option is suggested. This is called equity-at-default (EaD).

The VWO can create an interest-free debt contract by blending *murābahah* (cost plus a mark-up) or *tawarruq* (commodity *murābahah*) with charity. The principal of the



**Figure 7.**  
What the VPOs want?

**Source:** European Venture Philanthropy Association (2018)



**Figure 8.**  
Who funds the VPOs?

**Source:** European Venture Philanthropy Association (2018)

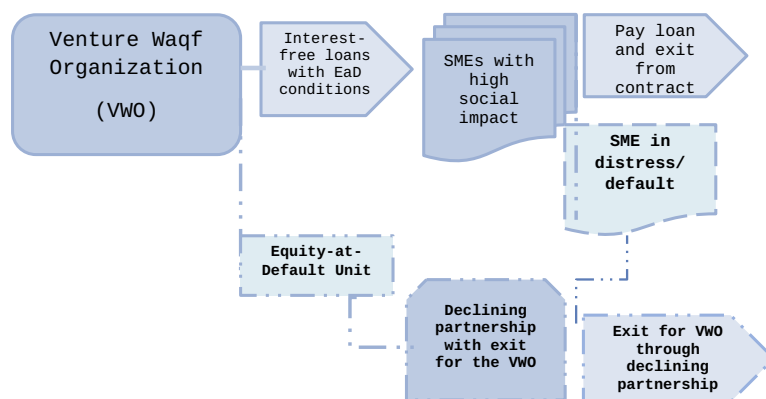
*murābahah* can be financing by one fund provider of the VWO, and the mark-up of the *murābahah* can be provided by another fund provider. For example, if the principal is 100 and the mark-up is 10, the 10 can be contributed through charity so that, for the SME, the 100 can become just like an interest-free loan.

Figure 9 provides the baseline EaD structure. The EaD is an interest-free loan (or any other Islamic debt-creating contract) that converts to declining equity at the trigger of a default event and hence replaces collateral requirements and foreclosure conditions. Therefore, the EaD is a potentially suitable contract for the VWO because the motivation of the VWO is the success of the high impact socially responsible enterprise.

At default, the value of an enterprise's equity will differ depending on the nature of financial contracts, whether based on collateral and foreclosures or alternatively based on partnership. The EaD is an equity builder, compassionate, interest-free loan (or any other debt instrument) that uses the beneficiary's potential equity to function as collateral. Owing to the equity building nature and compassionate design of the contract, at default, the expected value of the equity would be a certain positive amount, and instead of foreclosure, the defaulted debt would become a declining partnership.

Suppose that the loan amount is US\$50,000, which is now the value of the enterprise's merchandise in a new grocery store and which informally serves as the security/collateral for the loan amount due to cash flow problems, the enterprise defaults on the payment of a US\$5,000 instalment. Because of the EaD condition, the US\$5,000 defaulted amount would now become the partnership share of the VWO (financier). Consequently, the outstanding loan amount would be recalculated as US\$45,000. However, the value of the enterprise would still be US\$50,000 (assets US\$50,000, VWO equity of US\$5,000 (loan default), and loans US\$45,000).

Therefore, incentive-compatible interest-free loans to small and medium enterprises have perhaps the strongest anchoring potential for compassion within the framework of the financial services. An interest-free loan contract by the VWO for small, impactful businesses could also be a significant subsidy on funding for the enterprise and hence a solution to the exorbitant cost of finance for micro and small enterprises.



Source: Author's own

Figure 9. Baseline EaD structure

As a remedy against bankruptcy costs, the interest-free loan contract could have a built-in EaD arrangement whereby at default the financier would be an equity stakeholder in the small business. The condition could also introduce discipline and efficiency in the enterprise as well as in the lending culture and strategy of the philanthropic lender.

#### *Compassion in profit and loss sharing*

The prohibition of *ribā* (interest on loans and debts) and the fulfilment of other conditions of transparency, fairness, and ethics in financial contracts are meant to ensure compassion as a necessary ingredient in financial transactions. According to the distinct foundational principles of Islamic finance, rewards and returns from the ownership of an asset and the liabilities of that ownership are embedded, interwoven, and inseparable. Attitudes of individuals and firms towards ownership risks have crucial implications for their preferences for different forms of funds, and they differ in their feelings towards risk and return. Except for the prohibition of gambling, separation of risk of an asset from its ownership (as in interest-based transactions), and uncertainties due to gross asymmetric information related to contractual relations (as in *gharar*), no hard and fast rules are mentioned by Islamic economists regarding the Islamic temperament towards risk. The literature abounds with the argument that partnership contracts are fair and that they integrate compassion as these are based on risk/reward sharing based on mutual agreement. However, in view of the nature of the needs of ongoing businesses for finance and their own preferences for more independent ownership structures, some of the literature encourages more flexible, redeemable and forms of declining partnership. Many businesses would prefer these to the traditional forms of partnerships which are by their nature permanent and fixed such as *murābahah* (sleeping partnership) and *musharakah*.

As elaborated by Khan and Bendjilali (1996), a declining partnership contract based on profit and loss sharing offers a number of advantages if used by organizations with the purpose of making micro and small businesses successful.

- The declining partnership contract replaces the interest-based debt contract and allows for risk sharing, and hence is inherently more compassionate.
- By sharing the risk of small startup businesses, the contract encourages entrepreneurial activities.
- The contract replaces collateral and foreclosure with compassion and ownership sharing.
- Like the loan contract, it provides cash, and unlike partnership contract, it does not interfere in the ultimate ownership structure because of its redeemable nature.
- A venture investor decides on an exit strategy prior to entering into financing or investing, and declining participation offers that exit.

#### *Limitations of equity-at-default*

Banks may not find EaD attractive unless such banks adopt value-based intermediation approaches whereby the banks commit themselves to make responsible businesses successful. Such banks can pool together their social responsibility contributions to establish VWOs. If such a motivational purpose is adopted, banks can use the EaD for control and intervention to make the defaulting small businesses overcome the distress and stand on their feet within a certain time period. Indeed such purpose is more relevant for the VWO. However, banks can also participate in the VWOs with their own social responsibility



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concerns by contributing resources, technical advice, and in entrepreneurial capacity building for which the VWO provides a suitable platform and framework.

The general trend of rising compassion can be extended to commercial banks. Current accounts are a source of significant funds in commercial banks. For example, about 85 per cent of the total funds of some banks in Saudi Arabia (Al Rajhi Bank, 2018) come from current accounts. In other regional banks, this contribution of current accounts to total funds ranges from 30 per cent (Kuwait Finance House, 2017) to 65 per cent (Dubai Islamic Bank, 2017). As a consequence of these free funds, some banks are able to earn up to 16-20 per cent return on equity (ROE) (KPMG, 2018, p. 16). In the spirit of the rising global trend of compassion, and with proper regulatory oversight, part of these funds can be used, by banks in VW type of activities for extending interest-free loans to needy small enterprises based on the EaD concept. Special social responsibility reserves (SRR) funds can be established by banks with regulatory and philanthropic support to cover the risks of the interest-free loans extended to the small enterprises.

In the same spirit, a special new category of longer maturity (say two years) interest-free and special philanthropic-deposits can be created by banks. These funds could be used for equity building through interest-free lending to impactful small and medium enterprises (SMEs) on the basis of the EaD. Such deposits could potentially become popular if offered by credible and reputed banks with regulatory oversight and support. As suggested previously, the SRR funds would cover the risks of interest-free loans extended to the impactful SMEs.

The VWO offers a blended finance modality in which fund providers and other contributors have different motivations. For example, a contributor may offer a compassionate guarantee to a finance seeker. Some other contributors may offer interest-free loans. Still, other contributors may commit to meet accidental costs of beneficiaries. Redesigning SME finance initiatives by using the blended finance modality of the VWO creates an interesting prospect. The EaD concept potentially offers a refined and structured form of VWO going into administration from the outset in terms of default; especially, if the loan component is great, invoking management decision issues when such a situation actually happens. Banks may decide to sell their stake in such businesses; also, they are assumed to do their due diligence and would only fund projects that would serve a purpose instead of merely yielding great returns. So if the EaD causes a bank to be “locked up” in the business, it can sell its equity shares.

On the other hand, there is a potential incentive for default built in. Large firms would not default because they want to avoid foregoing a cheaper source of finance given the tax advantage of debt and if the return on equity  $ROE > (1 - t)r$  (where  $ROE$  = return on equity;  $t$  = tax rate;  $r$  = interest rate). However, small firms with more chances of default may renege on loans if expected  $ROE < (1 - t)r$ . This way, the beneficiary of the loan may become less careful in taking on risk given that the recourse to equity is last and without any further contingent liability after default.

We agree that given the relaxation to the borrower, in this case, such a product will be more useful to VPOs. Secondly, given the uncertainty of the investor/lender regarding default occurrence at present, such products if used extensively in commercial financing may add an extra premium in debt contracts given the asymmetric information about the probability of renegeing, default and business risk without recourse to collateral as in plain debt financing contracts. Thirdly, convertible securities are more in supply from large corporates; hence convertible securities of SMEs may not be as popular. Also, convertible security gives a chance to the investor to exercise conversion when  $RoE > (1 - t)r$ . Giving this conversion at default only means it would usually happen when  $ROE < (1 - t)r$  unless

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the conversion takes place at some significant discount to the market price of equity, which is difficult to know in small illiquid companies.

#### *Other equity-at-default-like examples*

EaD functions as an automatic stabilizer in case of distress. A number of other examples can also be mentioned, where intuitively, the relevance of EaD is significant. As such, EaD could perhaps have wider architectural implications for the global financial system.

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#### *Default risk of corporate, municipal and sovereign bonds*

In corporate, municipal and sovereign bonds, EaD will take the form of a binding condition in the contract whereby at default the investor in certain types of bonds will automatically become an equity holder in the issuers' business. For example, if the bond was issued to finance a solar energy storage project, and the issuer defaults – the bondholders would become owners of the project. A plain vanilla *ijarah sukuk* (lease-based *sukuk*) is the simplest baseline example of such a bond. To replicate the return and safety of a bond, the *ijarah sukuk* is issued on the basis of the issuer's credit risk. In normal times, the *sukuk* will earn the agreed rental income, and at maturity, the issuer will repurchase at the initial price. In case of default, the *sukuk* holders would invoke their ownership titles to the *sukuk* assets. Therefore, *sukuk* is a bond and becomes an equity stake in the *sukuk* asset in case of default.

#### *Integrating finance in the real economy*

The global economy is facing the rather threatening challenge of a complete disconnect between the financial economy and the real economy, with the financial economy exceeding the latter about eightfold. To illustrate, over-the-counter (OTC) derivatives at the beginning of global financial crisis were valued at about US\$672tn (BIS, 2008) while total world GDP in 2017 was about US\$75tn (Statista, 2017). This makes it seem as if the real economy needs to be integrated into the financial economy, but actually, the financial economy must be integrated into the real economy by supporting genuine businesses. The EaD condition offers strong incentives for financiers to select projects and businesses that will not default, and in unlikely cases of default, the financiers will assume ownership instead of pursuing costly bankruptcy procedures.

#### *Equities-at-default, mortgages and foreclosures*

In case of defaults in mortgages, instead of foreclosures, the financiers could take equity in the house after a fair valuation of the default. The prospect is that in such cases, house buyers and financiers will jointly own the houses and in case of further default the ownership of the financiers will gradually increase. The buyers will pay rentals on their declining portions of the houses. Manning's (2009) "Using Shared-Equity Agreements to Reduce Foreclosures: Policy and Analysis" is an interesting paper that discusses the different legal and regulatory aspects of similar structures.

#### *Securitization of equities-at-default and financial stability*

Financial crises have largely been attributed to extreme leverage and the resultant securitization of debts and collateralized debt obligations (CDOs). EaDs would be much more stable, and genuine substitutes for the CDOs and are expected to contribute to financial stability in comparison with the existence of markets for CDOs.

*Common equity tier-1 capital enhancement.* Certain types of deposits, certificates, and bonds issued by banks can be considered to qualify for binding conversion into common

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equity tier-1 based on regulatory acceptance and procedures. As reported by [Avdjiev et al. \(2017\)](#), this form of bank capital enhancement is already emerging in the form of contingent convertible capital instruments (CoCos).

#### *Government bailouts of distressed banks*

It has become a normal practice that governments take equity shares in distressed banks and gradually return the ownership shares to the owners after restoring normalcy. To the extent that the motive of this government action is to help the stressed banks to succeed, the act is philanthropic and parental in nature.

#### *Technology*

It is expected that the VW will leverage technology in two important areas. First, holistic strategy management systems enhance the performance of for-profit as well as not-for-profit entities. One such system is the Balanced Scorecard approach. By using this management tool, VW can make its performance robust. Second, distributed ledger technology (DLT) potentially enhances access of micro-investors and contributors as well as users. The VW can use such technology for accessing different types of resources as well as for management efficiency.

#### **Conclusion**

Venture waqf opens a potential new direction in the transformative role that waqf can play for internalizing compassion in financial contracting and in developing an Islamic vision of entrepreneurship for achieving a waste-free *halal* market economy. Blending compassion with the profit motive are inherent ideals of Islamic economics and finance; but under the influence of the dominant waste-driven economic and financial system, it has been pushed to the side. VW and EaD could potentially reform the financial architecture in a significant way. Lending on the one end and collaterals and foreclosures on the other end are the two pillars of the current financial architecture. EaD blends compassion with responsible profit motives and offers prospects to reform both pillars of the architecture.

There is a significant potential for lending to be based on philanthropic compassion. To offer affordable finance to micro, small, and medium enterprises with an objective of building the equity of such enterprises, compassion-based interest-free lending offers significant prospects. Potentially such lending could be done through VWs as well as through banks with proper regulatory oversight.

If the objective of extending finance is to build equity in a responsible recipient enterprise for its success and sustainability, then EaD offers better prospects as compared to costly collaterals and disturbing foreclosures.

We gave a number of examples where the potential benefits of EaD types of contracts are significant, and the limitations could also be challenging. The area is worth exploring both from financial innovation and policy perspectives, as part of the general academic pursuit.

To summarize, in this paper we suggested to:

- replace the current waste-driven linear economy paradigm with a new zero-waste *halal* circular economy paradigm consistent with the Islamic vision of entrepreneurship;
- establish a new form of waqf as a corporate entity, looking at the experience of the European VPO;

- assign a new purpose to waqf as a venture waqf with a predetermined exit strategy, to make impactful (zero waste *ḥalāl*) small businesses successful; and
- use a new baseline compassionate financial contract – an interest-free loan with a built-in condition that in the case of default, the defaulted amount will become the equity of the VW on a declining partnership basis. This is to replace collateral and foreclosure requirements of the existing interest-based lending instruments.

We understand that the paper opens a new area of further research and could potentially help policymakers to transition to a more responsible and compassionate zero-waste, free-market economy. At this stage, the subject matter could remain of academic interest for further discussion and research.

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