

FRAMING THE SOCIAL RESPONSIBILITY ROLE OF ISLAMIC FINANCIAL INSTITUTIONS WITHIN A THREE-SECTOR ECONOMIC MODEL

Mohd Nizam Barom

Department of Economics and Centre for Islamic Economics, Kulliyah of Economics and Management Sciences,
International Islamic University Malaysia.

mohdnizam@iium.edu.my

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Abstract

Purpose: This paper examines and reflects the ongoing debate on the social responsibility role of Islamic financial institutions (IFIs) in the light of the literature in the area of third sector and three-sector economic model. Subsequently, it seeks to develop a framework that can be used to conceptualise the potential interaction between the different sectors in the economy in relation to social welfare issues and locate the social responsibility role of IFIs within this framework.

Methodology: The paper uses an integrative analysis of Islamic finance and third sector literature, particularly on the American and European conceptions of the interactions between the three main sectors in the economy, i.e. public, private and 'third' sectors.

Results: The paper develops a modified circular flow of income and expenditure model as a basis for the integrative framework for social welfare provision within a three-sector economic model. Subsequently, it locates the social responsibility role of IFIs within this framework with the understanding that social welfare burden is a collective responsibility and therefore shared among the various potential welfare providers in the economy.

Implications: The integrative framework of social welfare provision within a three-sector economic model as conceptualised in this paper highlights a multi-institutional approach towards promoting socio-economic justice and society's well-being in an Islamic economy, and hence provides a proper and reasonable context for social responsibility roles expected of IFIs.

Keywords: *Social responsibility, Islamic economics, Islamic finance, Third or voluntary sector, three-sector economic model.*

INTRODUCTION

The conception of Islamic economics is strongly underpinned by normative foundations with the aim of realizing socio-economic justice and the betterment of human well-being. Dimensions of this socio-economic justice and well-being include the eradication of poverty, fulfilment of basic needs, development of human capital, equal opportunity, and equitable distribution of income, sustainable and holistic economic development, as well as social cohesion and moral excellence in the society of Muslim economies (Chapra, 1979). The emergence of the Islamic banking and finance industry in the 1970s was then touted to be the operational aspect of Islamic economics to achieve this novel aspiration. It was envisaged that the Islamic banking and finance industry would not only be more robust and efficient but also aspired to address the socio-economic predicament of the under-developed state of the Muslim economies (Chapra, 1985; Yusuf, 2015; Barom, 2018).

Nevertheless, there has been a contentious debate on the responsibility of Islamic financial institutions (IFIs) to bear this social role. Many industry players argued that IFIs are entities within the commercial sector of the economy, and therefore should not be burdened by these social roles (Ismail, 2002). Instead, the public sector and the third or voluntary sector are said to be the most appropriate institutions to address these issues. Despite the consistent call for IFIs to shoulder social responsibility roles by Islamic economists, and the increasing acceptance of IFIs on this responsibility off late (Ismail, 2014; BNM, 2018), there is still an absence of a macro model that can be used to conceptualize the potential interaction between the different sectors in the economy in relation to social welfare issues. This is in line with the concerns on the lack of sound theoretical foundations within the discipline of Islamic economics that can provide clear conceptual framework on the role of Islamic finance as one of the components of Islamic economics, in the realisation of the latter's objectives (Asutay, 2007; Farooq, 2008). While Islamic banking and finance industry has increased in both size and sophistication, the growth of literature in Islamic economics as the body of knowledge which supposedly supports the

underlying foundation of the practice has been severely compromised, as both practitioners and academics alike turn their attention to the rapidly expanding Islamic finance industry.

In light of the above, the objectives of this paper are twofold. First, it seeks to examine the debates on the social responsibility role of IFIs in the economy and reflect this using the framework available in the third sector and three sector economic model literature. These discussions are presented in Section 2 and 3 of this paper. Second, it seeks to frame the social responsibility role of IFIs within a three-sector economic model. To achieve this objective, Section 4 presents a modified circular flow of income and expenditure model as a basis for the integrative framework for social welfare provision in a three-sector economic model. Section 5 then locates the social responsibility role of IFIs in relation to other providers of social welfare in the economy. This integrated framework is expected to provide a proper and reasonable context for social responsibility role expected of IFIs as a constituent of the commercial sector among other sectors in the economy to cooperatively contribute to the betterment of human well-being and socio-economic justice in a more effective and systematic manner. The last section, Section 6 summarises and concludes the paper.

THE DEBATES ON THE SOCIAL RESPONSIBILITY ROLE OF ISLAMIC FINANCIAL INSTITUTIONS

The social responsibility role of IFIs has been a contentious issue since the emergence of Islamic banks in the early 1970s. The arguments for IFIs to take up this role have come from various grounds, including micro foundational assumption of homo Islamicus (Asutay, 2007), principles of Islamic moral economy (Farook, 2007; Hassan and Latiff, 2009; Zaman and Asutay, 2009; Nor, 2012), and the theory of *Maqasid* (Dusuki and Abdullah, 2007; Laldin and Furqani, 2013). For instance, Laldin and Furqani (2013) examine the notion and dimensions of *Maqasid* specific in the realm of Islamic finance. Based on an extensive survey of the available literature and the reading of the primary sources of the *Shari'ah*, they identify wealth circulation, fair and transparent financial practices, and justice at the micro and macro level as the three specific ends (*maqasid*) in Islamic finance. In order to realize these ends, they identify three important means (*wasail*) namely facilitating financial contracts, establishing values and standards, and instituting social responsibility. The recognition that social responsibility as one of the important components in realizing the objectives of the *Shari'ah* in Islamic finance is in line with the call by many scholars. This is crucial particularly in the light of findings that social responsibility initiative is not an integral and organized component of a majority of IFIs (CSR-IFI, 2010; Sairally, 2013).

Despite strong justification on the social responsibility concerns in Islamic economics and finance, there still exist some debates on whether such responsibility should be taken up within commercially oriented ventures or entities, particularly in the case of IFIs. On one hand, as organisations operating within the domain of the *Shari'ah*, it is argued that IFIs must not operate solely on profit motive, but are also expected to assist in the promotion of social justice and overall human well-being in line with the objectives of the *Shari'ah* (Chapra, 1985; Asutay, 2007). This view on the role of IFIs is known as the Chapra model (Lewis and Algaoud, 2001) and is in line with the normative goals of Islamic economics and overall Islamic worldview. Thus, the operation and policies of IFIs must be oriented towards the promotion of social justice and human well-being, such as promoting the equity-based participation in financing, providing financial capital to small and medium enterprise based on its viability, facilitating long-term development through the financing facility, reducing regional imbalances through investment in underdeveloped areas, as well as contributing towards the needy and the poor without undermining its commercial viability.

On the other hand, others argue that IFIs, which is a constituent of the 'commercial' sector, should operate as a commercially viable provider of *Shari'ah*-compliant financial services without being burdened by various social and welfare responsibilities. The proponents of this argument classify the economy into three distinct sectors; government, market or commercial, and the philanthropic, welfare or the third sector. Consequently, as argued by Ismail (2002), Islamic banks which belong to the commercial sector will have responsibilities to their shareholders and depositors and not to the larger society. The social responsibility of Islamic banks, therefore, is to continue to be viable and efficient in providing *Shari'ah* compliant financial services to their clients. Social welfare responsibilities, however, should be taken up by other segments of the society within the 'voluntary' or the 'third' sector, such as social and non-governmental organizations (NGOs). Some have also argued that morally or ethically motivated spending should be done at the 'disposal stage' (within the third sector) once the right on that wealth has been established at the 'acquisitive stage' (within the commercial sector) (Tag el Din, 2004). Again, this view creates a distinction between the motive and function of an entity in the commercial sector and the third sector. The above discussion signifies a perceived demarcation and dichotomy between the three available sectors in the economy, i.e. public sector, commercial sector and voluntary or 'third' sector. The next section of this paper examines and reflects the ongoing debate on the social responsibility role of IFIs in the context of the third sector literature and explores the potential of bridging the dichotomy between these three sectors.

REFLECTING THE DEBATES FROM THE THREE-SECTOR ECONOMIC MODEL'S LITERATURE

Etzioni (1973) is recognized in the literature as the one who first identified a distinct alternative sector which co-exists with the market and the state as the 'third sector'. However, numerous other terms are also used in reference to this sector, such as the non-profit sector, the non-government sector, civil society, the social economy and many more (Salamon and Anheier, 1992; Evers and Laville, 2004). The multitude of vocabularies to describe the sector reflects the wide-ranging types of institutions and activities within the sector. This includes charities, voluntary and community organizations, self-help groups, and depending on how it is defined, would also include organizations such as cooperatives and social enterprises (Evers and Laville, 2004). The complexity of the scope and nature of the third sector, the way it interacts with other sectors in the economy, and its increasing importance in social welfare provision have attracted a lot of interests among researchers in recent times.

The survey of recent three-sector economic model's literature reveals the presence of two dominant models defining the third sector and specifying the interaction between the third sector with other sectors in the economy. The American model of the third sector, as it is widely known in the literature, is the result of a comprehensive study done by John Hopkins Comparative Non-profit Sector Project (JHCNSP), which seeks to understand the complexities of third sector across countries (Salamon and Anheier, 1992; Salamon *et al.*, 1999). As a result, it has laid down five key characteristics of third sector organizations, based on a structural-operational approach. The third sector is defined to constitute organized/institutionalized entities, which are private in nature (institutionally separated from the government), self-governed, non-profit distributing, and have some voluntary element in its management and operation. A brief description of the five key characteristics which define the third/non-profit sector in the American context is presented in Table 1.

Table 1: Key Characteristics of the American View of the Third Sector

Key Characteristics	Description
Organized/institutionalized	The organization has some institutional reality to it, such as through a legal character of incorporation, some degree of internal organizational structure, relative persistence of goals, activities and some meaningful organizational boundaries i.e. recognized the difference between members and non-members.
Private	Not part of the government apparatus; structurally separated from the instrumentality of government, and do not exercise governmental authority.
Self-governing	Organizations must be able to control their own activities to a significant extent, have their own internal governance procedures, and enjoy a meaningful degree of autonomy.
Non-profit distributing	Profits, if any, are re-invested or applied to the stated purpose of the organization, and must not be distributed to the organization's owners, members, founders or governing board.
Voluntary	The organization must engage volunteers in its operations and management, and membership must be on a voluntary/non-compulsory basis.

Source: Salamon and Anheier (1992); Arshad and Haneef (2016).

The structural-operational approach in classifying third sector organizations, particularly the requirement of being non-profit distributing, has resulted in the third sector to be conceptualized as a separate independent sector without any overlap with the other two sectors, as depicted in Figure 1. For instance, some socially-oriented enterprises, such as the practice of social business/enterprise and cooperatives, are excluded from the third sector since they involve distributing profits to the owners and members, despite having social objectives. In sum, the model conceptualized three formally organized sectors, i.e. private, public and non-profit sector, as entirely independent of each other with their own characteristics, functions, and motives in the economy;

- Public sector- redistributive role; redistributing income and wealth for the provision of public goods and services and other social welfare aims.
- Private sector- acquisitive role; undertaking commercial activities for the purpose of income and wealth generation.
- Non-profit sector- transfers/disposing of income and wealth; voluntary and not for profit orientation with social objectives.

This model fits perfectly in the separation of roles in the economy as argued by Ismail (2002) with a clear dichotomy between the roles of the private commercial sector and the public and third-voluntary sector. Hence, this conception creates a conceptual barrier for private-commercial entities to have social objectives which is the distinct domain of the non-profit/third sector and the public sector.

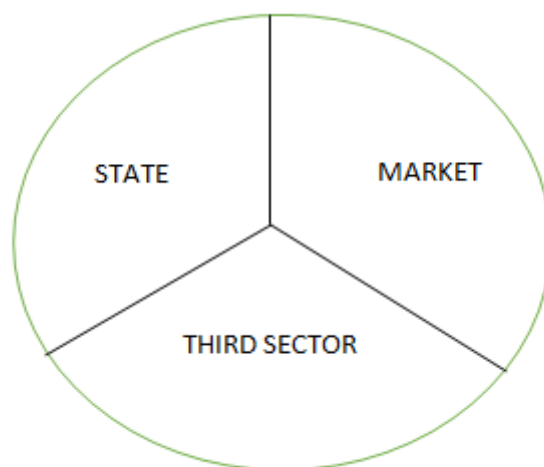


Figure 1: The American model of a Three-sector Economy

In addition to the above three formal-institutionalized sectors, the literature in the field of social welfare provision has also identified the informal sector in the form of families, neighbourhood communities and other non-formal groupings as an important source of social welfare. The importance of this informal sector is recognized by the seminal work of Esping-Andersen (1990) who developed the concept of a welfare triangle constituting market, state and 'families'. When 'families'/households sector is combined with the other three formal sectors, i.e. market, state, and the third sector, these four sources of well-being in the economy constitute the welfare diamond (Jenson, 2015). It is in this context that Evers (1995) conceptualized the third sector in the European context to be part of a welfare mix between the four potential providers of social welfare, where the third sector is located at an intermediate area rather than a clear-cut sector, often in the form of hybrids, "intermeshing resources and rationales from different sectors." This conception of a mixed, pluralistic, inclusive and intermediary nature of the third sector reflects well the traditions, historical legacy and economic environment of the European countries (Defourney and Pestoff, 2008).

The work of Evers (1995), Evers and Laville (2004) and Defourney and Pestoff (2008) among others, represent the European model of the third sector, and this is presented in Figure 2. Arshad and Haneef (2016) enhance the understanding of the figure by adding the numbering for different possible overlaps between the private, public and the informal household sector with the third sector, and this is also applied here. As shown in Figure 2, the European model integrates the third sector in a tri-polar relationship between state, market, and households, represented by area 1, 3 and 5 respectively. While third sector organizations can exist in its pure form, i.e. institutionalised (formal), private (non-government), and non-profit distributing, as shown by area 10 in Figure 2, the European model also recognizes the presence of hybrid entities between the three other sectors with the 'pure' third sector, as shown by area 2, 4 and 6 in Figure 2. These entities may not fulfil the structural-operational definition of third sector organizations but nevertheless share the normative value of promoting socio-economic justice and well-being of third sector organizations, and therefore included in their conception of the broader third sector. Hence, in the European context, the third sector is represented by the middle circle encompassing the 'pure' third sector organizations in area 10, as well as the hybrid entities within area 2, 4 and 6. Other areas, such as 7, 8 and 9, represent the potential overlap between state and the household sector, state and the private sector, and private and the informal sector, respectively.

In the context of this paper, the focus is on area 3 and 4 in Figure 2, where IFIs are possibly located. While both are within the domain of private-for profit-commercial activities, there is a big difference between the two. Area 3 represents a typical profit-maximizing firm where values such as self-interest, individualistic and competition are dominant (Arshad and Haneef, 2016). This is in contrast to area 4, where despite the presence of profit motive, values such as socio-economic justice, collective interest and cooperation serve the underlying operating principle of the organization. Hence, unlike the American model, the European model of a three-sector economy recognizes the natural occurrence of overlaps between the structure, function, and motive of various organizations, including private-commercial entities who may share the social

objectives of the third sector. In other words, commercial activities and social objectives are not mutually exclusive domains, and this is something that is increasingly becoming more significant in the global business community.

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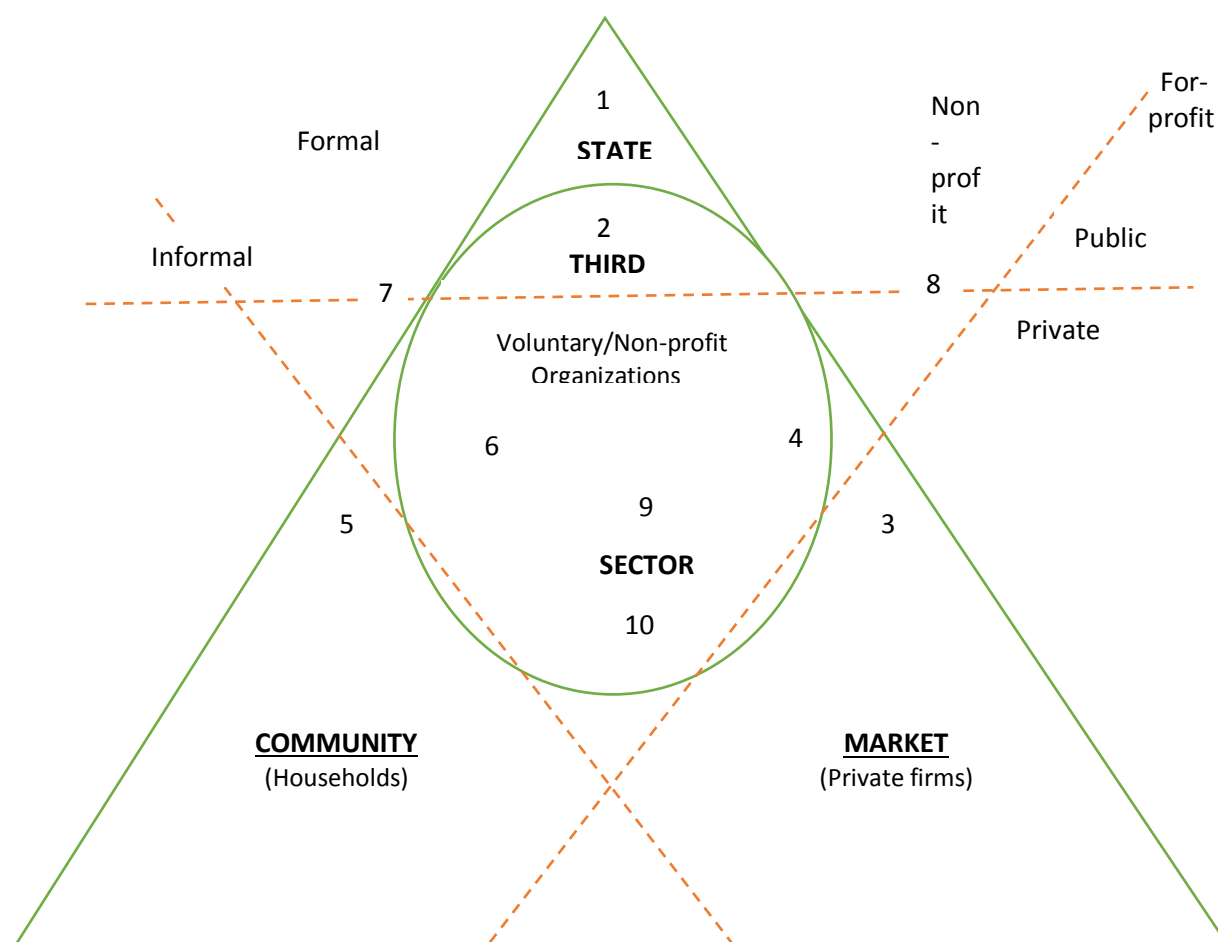


Figure 2: The European Model of a Three-sector Economy
Source: Defourney and Pestoff (2008); Arshad and Haneef (2016).

The pluralistic and mixed nature of the European conceptualization is in line with the Chapra model for IFIs. Despite structurally-operationally a private-commercial entity, the principles underlying the practice of IFIs are founded on the Islamic legal and ethical system, with the aim of fulfilling the *Maqasid* or the objectives of the *Shari'ah*. Thus, in this conception, the operation and policies of IFIs are expected to be oriented towards the promotion of social justice and human wellbeing without undermining its commercial viability. While this understanding has gained acceptance among the industry players, it is also important to frame the social responsibility role of IFIs within a proper context, i.e. within the overall scheme of social welfare provision in an Islamic economic system.

AN INTEGRATIVE FRAMEWORK FOR SOCIAL WELFARE PROVISION

In locating the potential role of IFIs in promoting socio-economic justice and overall well-being, the universe of a social welfare mix presence in a three sector economy together with the informal household sector should first be identified. As discussed in Section 3, literature in the field of social welfare provision identifies a number of important actors and the division of responsibilities among markets and states as well as among families and communities (Jenson, 2015). With this in mind, the paper develops a modified circular flow of income and expenditure model, as depicted in Figure 3, as the basis

for a framework that integrates the four sources of social welfare provision, i.e. the three formal sectors of private, public and third sectors, alongside the informal sector of the household, and locate the social responsibility role of IFIs in this framework.

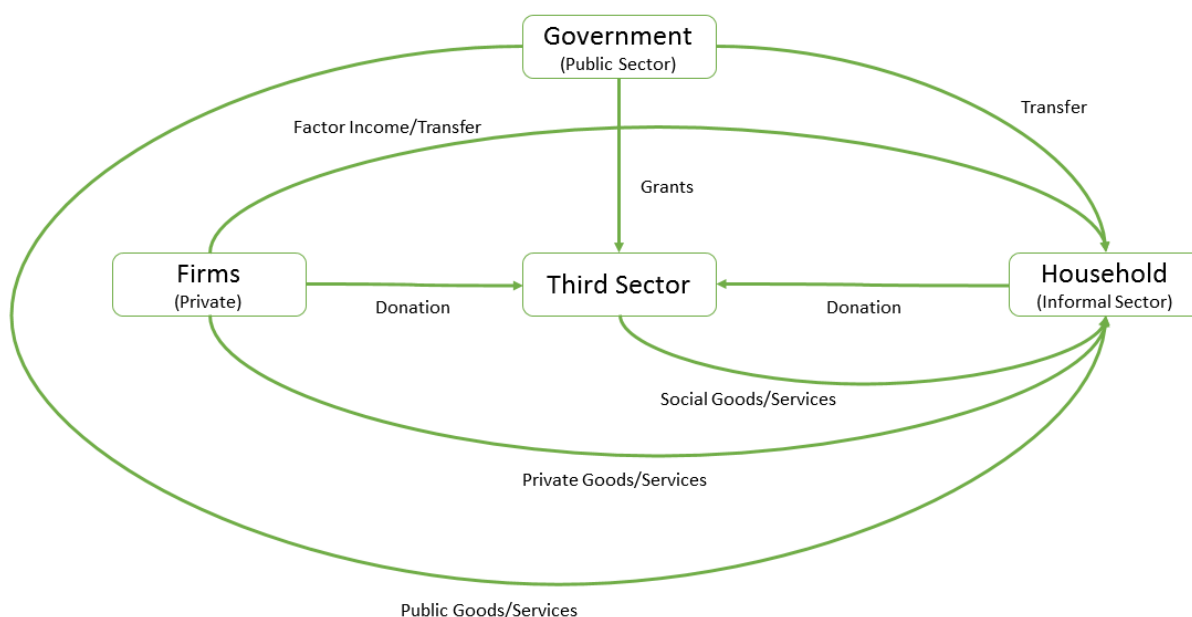


Figure 3: Integrated Framework of Social Welfare Provision in a Three Sector Economic Model

Based on Figure 3, the following points briefly discuss the role of the different sectors in social welfare provision;

- Private sector- Private firms have the responsibility to create well-being by going about its business profitably, producing goods and services for the society as well as creating employment and generating income to the people participating in the production process. This is shown by the flow of factor income from businesses to households in Figure 3. For majority of the people, the major source of welfare, i.e. enabling consumption expenditure for private goods and services, is from this income, either by themselves or someone in their family, such as a spouse or a parent. Additionally, private businesses can also involve in providing transfers directly to the households (e.g. scholarships to poor students, donations to orphanages and mosques, etc.) or indirectly through contributions to charities/third sector organizations.
- Public sector- As expected in the economy, social welfare is provided by the state, primarily in the provision of public goods and services such as health care and education for free, or which the people are not required to pay full market prices, as well as by income transfers to households from its tax or other revenues. Similarly, the government can also support third sector organizations through providing grants and other support to encourage and facilitate social welfare initiatives by the third sector organizations.
- Household sector-Many forms of well-being involve non-market transactions, often involving benefits and services provided within the family, such as parental childcare, housework, and care for elderly relatives. Income transfers are also applicable directly from the rich to the poor segments of the households. These two items, however, happens within the household sector and are not shown as part of the flows in Figure 3. However, the rich segment of the households may contribute indirectly to the social well-being of the underprivileged through their contributions (i.e. in cash, kind or volunteering) to charities/third sector organizations, and this is shown in the flows of donations from the household sector to the third sector in the figure. Households are also involved in many informal community activities that may contribute to social well-being.
- The third sector at the centre of the figure generates welfare by providing social goods and services (as well as transfers, volunteer activities, non-market exchanges, etc.) for free or at below market prices, using resources it receives from the private, public and the household sectors.

The combination of these four sources reflects the overall level of well-being in the economy. On the basis of the actors and sources of social welfare above, the paper proceeds with the discussion on locating the social responsibility role of IFIs as the constituent of the commercial/private sector in relation to other sectors in the economy.

FRAMING THE SOCIAL RESPONSIBILITY ROLE OF IFIs

The emergence of the Islamic finance industry as the offshoot of Islamic economics movement was expected to be the operational arm of Islamic economics in realizing its aspirations. However, at the early stage of its development, IFIs were grappling with challenges and the focus was to prove their viability and to survive in the financial market, hence providing a plausible reason for its initial state of denial on their social responsibility role. Since then, three important developments worth noting. First, there is an increasing acceptance by the industry players on the social welfare role of IFIs off late. Among others, the factors contributing to this include;

- Persistent criticisms on the lack of social welfare initiatives by IFIs among scholars of Islamic economics and finance
- The use of *Maqasid framework* as a strong theoretical and practical justification for IFIs to look beyond the contractual forms of financial transactions towards the social outcome of their operations
- The mainstreaming trends of social responsibility worldwide among corporations and financial institutions

Second, the denial syndrome for social responsibility role (at least at the initial years), and the lack of social responsibility initiatives among the IFIs have prompted some scholars of Islamic economics and finance to shift the focus to other potential institutions and instruments to promote socio-economic justice and well-being in the economy. For instance, in addition to the institution of zakat, there is an increasing call for the revival of *waqf* institutions as a major instrument towards realizing socio-economic well-being. These two institutions, which were the essential pillars for social security and services in the early periods of Islam, have lost their significance as a result of colonialization. This two institution alone, if properly revived, optimized and mobilized, could already meet the funding requirement for pro-poor social programs for the societies of Muslim countries (Shirazi, 2014). They can also be the foundation for flourishing third sector activities in Muslim countries (Arshad and Haneef, 2016). Based on the European conception, these two institutions can be perceived as pure third sector organizations.

Thirdly, beyond the above charity-based institutions, many forms of commercial entities that share the social objectives have also gained significance in the Islamic finance realm. Islamic microfinance, or also known as Islamic social finance, has proliferated to fill the gap left by IFIs and potentially benefiting millions in improving their standard of living through the financing of various entrepreneurial activities (Rahim, 2010). Additionally, crowd-funding platforms, which can be used to mobilize funds for social welfare objectives, and the emergence of social enterprises, with the aim of creating a positive impact to the society through their business, add to the existing mix of available commercial but socially-oriented institutions capable of contributing to the well-being of the people (Hoque et al., 2018; Aydin, 2015).

The discussion in Section 4, and the preceding discussions in this section has some important implications in framing the social responsibility role of IFIs;

- The proliferation of various forms of entities such as Islamic microfinance, socially oriented crowdfunding platforms, social enterprises, and cooperatives has spread out the social welfare burden previously mounted primarily on the shoulder of IFIs in the early periods of its emergence. This enables some essential social responsibility role such as poverty eradication efforts, social protection, or micro-entrepreneurial development, which are not effectively addressed by IFIs being addressed by these other entities.
- The increasing awareness on the huge potential of third sector entities, particularly the institutions of zakat and *waqf*, in providing social goods and services left unfulfilled by the public and the private sectors, has stimulated serious efforts towards the systematic institutionalisation of these institutions in the economy, such as being done in Indonesia (Firdaus et al., 2012) and by the Islamic Development Bank (Shirazi, 2014). The presence of a strong third sector in Muslim countries would further enhance the availability of social welfare providers in the economy, and further spread out the social welfare burden expected of IFIs. In this context, it is to the benefit of IFIs that it contributes to the strengthening of the third sector with its resources, e.g. through corporate social responsibility initiatives focussing on enhancing the professionalism of third sector organizations.
- A responsible and people-centric government in the public sector, together with a strong family, neighbourhood and community spirit within the household sector, are also important sources of well-being in the economy. While the former is well-recognized, the latter component of social welfare needs to be further promoted to achieve its potentials in the overall scheme of social welfare provision.

While the social responsibility role of IFIs, as identified and discussed within the context of the Chapra model, has increasingly being accepted, this integrative framework is believed would further enhance this acceptance. The framework, as shown in Figure 3, represents a macro model of a cooperative setting in which all sectors in the economy cooperatively

contributing to the social well-being of the society. This framework provides a full perspective on the different actors and sources of social well-being without overemphasizing any particular organizations. This provides a proper framing of the social responsibility role of IFIs in relation to the broader efforts towards realizing socio-economic justice and well-being in the economy. In sum, this framework emphasizes a multi-institutional approach towards promoting socio-economic justice and society's well-being in an Islamic economy and provides a proper and reasonable context for social responsibility roles expected of IFIs.

CONCLUSION

This paper has examined the ongoing debate on the social responsibility role of IFIs and explores the potential of bridging the dichotomy between the three main sectors. A survey of the three-sector economic model's literature revealed the presence of two dominant models specifying the interaction between the three main sectors in the economy. In the American model, the third sector is conceptualized as a separate independent sector without much overlap with the other two sectors. This model fits well with the separation of roles in the economy as argued by Ismail (2002) with a clear dichotomy between the roles of the private commercial sector and the third-voluntary sector and the public sector. On the other hand, The European conceptualization of a three-sector economy does not strictly follow the structural-operational definition of third sector classification as in the case of the American model and include normative approach in its definition of the third sector. While third sector organizations can exist in its pure form, i.e. institutionalised (formal), private (non-government), and non-profit distributing, the European model also recognizes the presence of hybrid roles and entities in between the sectors which may not fulfil the structural-operational definition of third sector organizations but nevertheless share the normative value of promoting socio-economic justice and well-being. This conception is considered to be in line with the Chapra model on the role of IFIs, i.e. Despite the presence of profit motive, values such as socio-economic justice, collective interest, and cooperation serve the underlying operating principle of the organization. This provides the premise for a more participatory role of IFIs in facilitating socio-economic justice and well-being along with its profit motive, reflective of its underlying operational principles and goals, i.e. the *Shari'ah* and its *Maqasid*.

Subsequently, the paper frames the social responsibility role of IFIs within an integrative framework of social welfare provision within a three-sector economic model with the understanding that the social welfare burden is a collective responsibility and therefore shared among the various potential welfare providers. Literature in the field of social welfare provision identifies a number of important actors and the division of responsibilities among markets and states as well as among families and communities. The process of social welfare provision is highlighted through a modified circular flow model of the economy, comprising all the three formal sectors of private, public and third sectors, and the informal sector of the households. Subsequently, the social responsibility role of IFIs is framed within this integrated framework and in the context of the recent proliferation of various other forms of commercial but socially oriented entities within the realm of Islamic finance., in which the role of IFIs in the society can be seen from a much fuller perspective along with the other sectors in the economy. This integrative framework highlights the multi-institutional approach towards promoting socio-economic justice and society's well-being in an Islamic economy and provides a proper and reasonable context for social responsibility roles expected of IFIs. With the right perspective, IFIs may be more willing to commit for social responsibility as this is seen as more cooperative efforts and escape itself from the state of denial mode for its social responsibility roles.

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