

The Future of Islamic Social Finance: “Can Digital Solutions Bridge the Financial Gap?”

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Abstract

Islamic Social Finance (ISF) is a philanthropic framework aimed at enhancing societal and economic well-being through ISF instruments such as Zakat (mandatory almsgiving), Waqf (charitable endowment) and Sadaqah (voluntary charity). These platforms serve as foundational mechanisms for promoting social welfare and equitable wealth distribution, hence, fostering financial inclusion within society. However, there are several challenges in ensuring an effective ISF management, and lack of comprehensive understanding of ISF remains prevalent within the society. The objective of this study is to propose several digital solutions such as mobile apps and Artificial Intelligence (AI) driven tools, integrating financial education practices to promote financial inclusion and enhance ISF management efficiency. This study employs library research and analyzes relevant academic and industry articles. It concludes with recommendations for consideration by the authority.

Keywords

Islamic Social Finance, Financial Education, Finance Inclusion, Digital solutions

Introduction

Islamic finance aligned with principles that share resemblance to social finance. It encompasses values such as risk-sharing and emphasizes the importance of social justice and welfare. Throughout Islamic history, there are clear and indisputable examples of using Islamic financial instruments, such as zakat, sadaqah and waqf (Kamdzhlov, 2022).

Islamic social finance (ISF) refers to financial practices that combine with ethical principles and Islamic teachings to prioritise social welfare and community development. The objective of this practice is not to seek profit or benefit but to gain reward and help the society. Adinugraha et al. (2023, as cited in Ascarya, 2018) emphasised that ISF is a development of new knowledge in Islamic economics, whose goal is to balance groups with excess funds and those lacking funds.

These channels are utilized to mitigate poverty, support underserved populations in enhancing their standard of living, and address their needs through leveraging the resources distributed via waqf, sadaqah, or zakat. When these resources are effectively utilized, underserved populations can contribute back to society and fulfill their obligation for example paying zakat.

Srilestari (2024) suggests that ISF plays a vital role in offering financial support to those in need while adhering to Islamic ethical principles. However, to stay efficient and impactful, ISF must adapt to the challenges of the new normal and integrate advancements in digital technology for greater effectiveness in benefiting society.

This study aims to propose digital solutions to improve the effective use of digital technology in ISF, ensuring it remains ethical and relevant. The goal is to help everyone adapt to these changes and enhance fund distribution to bridge financial gaps.

Literature review

This section will provide a detailed discussion on Islamic finance, its principles, and its integration with ISF, along with an explanation of its instruments. It will also state the challenges related to financial gaps in ISF and explore digital solutions like the implementation of fintech in ISF.

Islamic Finance

Islamic finance is one of the financial systems used in banking that adhere to Islamic law, where the use of interest (*riba*) in money lending, uncertainty (*gharar*) in contracts, financing transactions containing gambling elements (*maysir*), and any prohibited activities such as selling alcoholic beverages or offering pornography services are prohibited in Islamic banks.

The promotion of Islamic finance relies heavily on the active participation of individuals in various aspects of life, including worship, preservation of life, protection of religious values, engagement in productive endeavours, and advocacy for justice (Ahmad et. al, 2011). Islamic finance promotes adherence to Islamic principles in wealth management, emphasising practices like *zakat* and *sadaqah*. Additionally, it advocates for ethical investment strategies, such as investing in projects that enhance public welfare while avoiding sectors harmful to human well-being.

By adhering to Shariah-compliant financial principles and refraining from investments conflicting with Islamic beliefs, Islamic finance contributes to the preservation of religious integrity. It channels funds towards the enhancement of mosques and the promotion of educational initiatives aligned with Islamic teachings. Furthermore, Islamic finance facilitates funding for businesses and ventures that generate permissible income, encouraging individuals to partake in economically beneficial activities in line with Islamic values, such as *Mudharabah* and *Musharakah*.

Finally, Islamic finance prioritises fairness, transparency, and ethical conduct in financial dealings, denouncing practices like interest and exploitation. According to Kamdzhlov (2022), Islamic finance, as a socially responsible practice, has the potential to mitigate adverse economic impacts. Its fundamental principles of asset-based financing, integrated with innovative technologies like blockchain, introduce fresh ideas to modern financial systems. This commitment will ensure equitable wealth distribution and equitable treatment of individuals in economic transactions.

Islamic Social Finance

Islamic social finance refers to a component of Islamic finance methods and principles that are centered on resolving humanitarian and social challenges. This form of finance aims to promote social welfare and encourage people on accountability of social responsibility in tackling financial gaps of the underserved population.

Key instruments such as zakat, sadaqah, and waqf are integral to its practice. These tools not only provide immediate relief to those in need but also work to create long-term solutions for poverty alleviation and community development such as reducing unemployment, in which it can guide people to generate their own income and give back to the society.

The presence of ISF fosters a sense of responsibility in individuals to assist those who are less fortunate. This concept is vital in Islam as it purifies wealth, recognizing that within every person's earnings, there is a portion allocated for those in need. The distributive nature of ISF ensures that resources are allocated fairly, promoting social equity, and reducing economic disparities.

By doing so, it addresses fundamental social challenges such as reducing inequality, improving access to necessities, and fostering social equity. In essence, Islamic Social Finance serves as a vital framework for promoting a holistic approach to social justice and inclusive economic development, bridging financial gaps while aligning with the ethical values of Islam.

i) Zakat

Zakat, derived from the Arabic word meaning "to purify," refers to the mandatory distribution of wealth to eligible recipients in accordance with the eight asnaf. As one of the Five Pillars of Islam, zakat is a religious obligation for mukallaf who possess surplus resources. It serves as means to cleanse their wealth and fulfill their duty to society.

As stated by Hamed (2020), zakat is a reliable means of reducing poverty eradication, which provides a permanent mechanism from within the economy to continuously transfer income from the rich to the poor and that once correctly assessed, promptly collected and properly disbursed. Zakat is divided into two main types: zakat al-mal and zakat al-fitr. Among these, zakat al-fitr holds particular priority as it is an annual obligation during the month of Ramadan. It must be paid before Eid al-Fitr (the start of Syawal) to ensure that those in need can meet their basic necessities and celebrate the occasion with dignity.

The primary purpose of zakat is to combat poverty and alleviate the hardships faced by the less fortunate. It acts as a redistributive mechanism, ensuring a fair allocation of wealth within society. In Islam, supporting the poor is not merely an act of charity but an essential form of justice, reflecting the collective responsibility of society for the welfare of all its members. This approach underscores the moral and ethical duty to create a balanced and equitable community.

ii) Sadaqah

Sadaqah, meaning charity, refers to the voluntary act of helping others and is regarded as one of the simplest forms of kindness, even a smile is considered sadaqah. Sadaqah does not require a specific amount, as it is a voluntary act, and its true value lies in the sincerity of the giver. Contributions are not limited to monetary donations but can include items such as clothing, stationery, or other essential necessities. This flexibility makes sadaqah one of the simplest acts of kindness that anyone can perform. Moreover, there are no restrictions on when sadaqah can be given, allowing it to be practiced freely at any time and in any place.

Sadaqah is frequently offered in response to misfortunes or disasters, acting as a collective support system that reflects the unity and strength of the ummah. The assets collected through sadaqah can either be directed to individuals in need or distributed more broadly according to the giver's

intentions. This act of giving reinforces compassion and solidarity within society, emphasizing the importance of helping those in need.

iii) Waqf

Waqf or Islamic endowment, or the plural 'Awqaf' is an Arabic word which means 'restriction' because we acknowledge that all properties belong to Allah. According to Islamic Development Bank, waqf are assets that are donated, bequeathed, or purchased for being held in perpetual trust for general or specific charitable causes that are socially beneficial. Bouakkaz (2022) describes waqf as the confinement of the asset so that it is not disposed of by sale, gift, or inheritance, and directing its gains to a destination of righteousness. Waqf has wide economic implications and can play an important role in increasing social welfare.

The characteristics of waqf are permanent, which means, if the endowment has already been recognized as a waqf, the individual who gave it is not allowed to revoke it. This implies that the waqf exists purely for philanthropic reasons and the community will always benefit from it. The second point is, the asset must be continuous because according to 4 major schools of thought (Hanafi, Maliki, Shafie, and Hanbali), once a waqf asset is given, it must remain perpetual. This ensures that it will continue to benefit future generations and forbids it from being confiscated. Lastly, waqf assets are forbidden from being sold. Although the advantages of the contribution benefit mankind, it is believed that every property is owned by Allah. No individual is eligible to become the owner, hence, the waqf becomes a "common asset." which cannot be bought, sold, mortgaged, gifted, or inherited.

When an asset is designated as waqf, individuals can benefit from its use while the asset itself remains preserved. Waqf has been used to support and fulfil the needs in education, social and religious initiatives. Through waqf, society can thrive, as waqf contributions can range from small items like school facilities to larger initiatives such as dedicating a building, for example, the first waqf university in Morocco, University of Al-Quarawiyyin or providing land for green waqf projects. The waqf concept can be further developed to address modern needs while staying true to its foundational principles of fostering social welfare and community development.

Methods

This study relies heavily on the extraction, review, and utilization of existing scholarly works and available data related to Islamic social finance and financial technology (fintech). These prior studies not only serve as the main sources of reference but also provide valuable insights, theories,

and empirical findings that will be integrated into the discussion. By drawing upon and critically analyzing these existing contributions, the paper aims to build upon established knowledge, strengthen the validity of its arguments, and highlight the relevance of Islamic social finance and fintech within the broader academic and practical context.

DISCUSSIONS

Observation

The adoption of digital ecosystems has become increasingly prevalent across various industries, including the financial sector and ISF. This approach incorporates diverse digital tools to promote secure and transparent methods of operations. Digital ecosystems offer innovative solutions to address challenges within ISF, utilising technologies such as digital wallets, mobile applications, FinTech, blockchain and smart contracts. These tools collectively enhance efficiency and effectiveness of operations, ensuring streamlined and reliable processes.

Mohamed Salleh et al. (2019) explores the transformation of zakat collection and distribution through digital wallets, focusing on the integration of blockchain technology within the framework of Maqasid Shariah. Their study examines the potential of zakat as a tool in achieving social justice and facilitating social financing while evaluating the benefits of blockchain in enhancing zakat processes. The study highlights the importance of an efficient zakat system leveraging blockchain to ensure secure, transparent, and cost-effective transactions. It proposes digital wallets as a streamlined solution for zakat payments, emphasizing the need for accountability, transparency, and Shariah compliance. Clear regulatory guidelines grounded in Maqasid Shariah are deemed essential for effective implementation.

Similarly, the implementation of fintech has greater benefits for any financial sector. For example, India has done a study on the role of fintech mechanisms on economic inclusion in India. Finding showed that fintech is a device to replace the traditional banking system that provides secured and private components. Meanwhile, in Indonesia, adoption of Shariah fintech, or Islamic fintech, has been studied to measure the Islamic economic development through implementation of Shariah fintech. The growth of a nation requires a more integrated approach and system to enhance social welfare as well as economic growth. The study shows that Indonesia has the largest fintech market in Southeast Asia. According to the Indonesian Fintech Association (IFA), the number of fintech players has grown up to 78% in 2016. (Muchlis Bahar, 2002). From the studies

mentioned above, it shows that fintech is welcome in any sector and has been practiced in many countries as it facilitates to meet the financial needs of the society and economy.

A case study on Finterra, a FinTech platform showcases blockchain's role in advancing Islamic finance in Malaysia. It facilitates cash waqf and crowdfunding for charitable causes, enhancing zakat transparency and efficiency through smart contracts. This aims to ensure a secured and streamlined operation. The study highlights fintech's potential to effectively manage funds and boost public participation in ISF.

i) Development Of Digital Ecosystem in Brunei

Brunei Darussalam has taken the initiative to embrace the digital ecosystem for financial development of the country. Brunei Darussalam Central Bank (BDCB) has established regulatory sandboxes as a support for fintech development in Brunei, while complying with the regulations set by BDCB. Moreover, majority of financial institutions in Brunei have implemented fintech and implement digital platforms in their banking operations, for example, Bank Islam Brunei Darussalam (BIBD) itself has established its own mobile application, BIBD Nexgen, which offers digital banking where transactions are made easier using this platform. The government has also provided initiatives in ensuring the safety and security of implementation of fintech through issuance of regulation and guidelines by BDCB which is mandatory for all financial institutions in Brunei Darussalam to comply.

Digital practices have gained its importance especially in the pandemic era when COVID-19 hits Brunei in March 2020. During this pandemic, the government has come up with numerous initiatives to provide the best solution for the public. In April 2022, Islamic religious council, or commonly known as Majlis Ugama Islam Brunei (MUIB), issued zakat payment and zakat collection guidelines in combating the COVID-19 outbreak as one of the preventative measures taken by the government to avoid direct contact during Eid, where payment of Zakat Fitrah was made available online through collaboration with numbers of local agencies.

Brunei Darussalam is encouraged to widely practise and implement digital solutions in Islamic social finance sector as it can maximise the number of benefits for both social and economy. With this alternative, Islamic social finance sector in Brunei can enhance the efficiency of Islamic social finance to provide best solutions for the collection and distribution of charitable funds. Users can

easily access and participate in charitable activities more conveniently through internet and digital platforms. Moreover, blockchain technology and smart contracts ensure the transparency and accountability of transactions directly for the charitable activities they intend to be part of, which is also essential for maintaining public trust. Hence, the growth of Islamic social finance can be supported through digitalisation in this sector.

ii) Opportunities to Develop Digital Ecosystems in Islamic Social Finance

Technological advancements have profoundly influenced daily life, creating opportunities for the integration of digital ecosystems within ISF through a unified platform. The globe has witnessed a surge in digitalization during this pandemic era in 2019, with digital technology where the internet has become a daily part of individuals that has the accessibility to these facilities. The financial industry views this as an excellent opportunity to offer services that are made convenient by digital technology such as digital wallet, online payment services and digital banking. This included the digitalisation of Islamic social finance such as zakat collection and distribution. For example, in South Kalimantan, Indonesia, several initiatives have been introduced during the pandemic to minimise contact such as zakat pick-up services and banking services transfers (Maulida et. al, 2021).

This comprehensive digital ecosystem aims to gather donors, recipients, managers, and regulatory bodies onto a single platform. Various digital platforms can be introduced to promote efficient and convenient Islamic social finance such as digital wallets and mobile applications. This paper aims to elaborate further on the opportunities of creating digital platforms to promote Islamic social finance and bridge the financial gaps. According to Bank Indonesia's research result, as cited by Munifatussaidah et. al (2024), digital wallet, also known as E-wallet is a server-based electronic money to make digital payments without using cash. Digital wallets typically focus on money management and will feature key functionalities such as payment storage, automated transaction processing, enabling secured and fast transactions. Additionally, digital wallets should integrate the ISF concepts while incorporating features that allow users to contribute to charity, make online zakat payments and make charitable donations (sadaqah) as well as trackable contributions to Waqf initiative.

In addition to digital wallets, mobile applications can integrate the digital ecosystem while aligning with Islamic social finance concepts. A mobile application will provide users with easy

access to information through a central hub featuring useful functionalities related to Islamic social finance. These may include educational content, updates, zakat calculators, guides and tutorials in performing sadaqah and waqf through a real-time monitoring system via online dashboard. For instance, different countries have implemented these digital platforms such as PayZakat (Malaysia), GoZakat (Indonesia) focusing on zakat payment platforms. Additionally, a crowdfunding platform has been widely adopted in Malaysia such as E-Waqf, Global Sadaqah and Launch Good.

In the context of Islamic social finance, these digital platforms are designed to offer an immersive user experience with diverse functionalities, including but not limited to financial transactions. Therefore, digital wallets and mobile applications serve as initiatives in bridging the financial gap, in which these platforms by offering easier and more streamlined zakat platforms, supplemented with real-time monitoring and fund tracking. For ISF management, this digital ecosystem is particularly useful as it enhances transparency between users and management regarding fund allocation, ensuring fairness and that funds reach the intended recipients. Consequently, the digitalisation of ISF reinforces trust and accountability among users while expanding access to underserved populations.

Challenges

The practice of ISF is often treated as seasonal; zakat is typically emphasized during festive periods like Eid, while sadaqah is mainly collected in response to disasters or crises. Additionally, transparency is a significant concern. In crowdfunding campaigns, for example, there are instances where the intended recipients are not clearly identified, and organizers fail to provide evidence that the funds have reached the rightful recipients.

Limited accessibility in underserved areas further hampers the effectiveness of ISF. For instance, in Brunei, there is a significant number of underserved populations who remain undiscovered, despite the availability of surplus zakat funds. This mismatch raises questions about the management of zakat, as funds collected often exceed the number of identified recipients, leaving the allocation of these resources unclear. According to Fauzia (2020), cited from Maulida et al (2021), the effectiveness of digital zakat cannot be generalized as there are numbers of population lived in rural areas who do not have access to financial services as well as internet, in which only can be executed through zakat collector.

According to research studied by Maulida et al (2021) which aimed to analyse the problems and solutions managers face in managing zakat funds through digital platforms. The study by National Committee for Islamic Economy and Finance (KNEKS) in 2020 in South Kalimantan showed that the comprehension regarding zakat concept among the people still need to be studied, hence, digitalise zakat management should be review and assess its relevancy and compatibility with the current community conditions.

These challenges are not limited to the recipients only, according to Maulida et. al (2021) in-depth interview, it includes various factors that may hinder the effectiveness of digitise zakat management platforms, which categorise into an internal and external problem. The analysis suggests that the majority of zakat management institutions have been dominated by digital collection, in which it is convenient to disseminate information through digitalisation. However, the digital zakat management process might be affected due to limitation of knowledge in digital literacy among *muzakki* (zakat payers) especially in collection, distribution, socialisation and promotion. The result of this study showed a significant increase in the readiness of zakat management institutions in utilizing digital platforms to be integrated in their system.

The process of digitalisation is closely associated with cybersecurity, as every implementation of digital systems must prioritize robust cybersecurity measures to safeguard financial and confidential data. Neglecting cybersecurity can lead to cyberattacks and cybercrimes, including data theft. Any entity should establish comprehensive cybersecurity policies and guidelines that are also Shariah compliant to ensure the safety of their process and to enhance trust between the organization, public, recipients or donors.

Suggestions

It is recommended that digital ecosystems be brought to the ISF market to capitalize on the opportunities that digitalization presents for all users. By offering these digital solutions, it could address certain of the issues that arise in ISF and serve as an avenue for advancing greater knowledge of Islamic finance.

A study on use of E-wallet to pay *zakat* during COVID-19 pandemic among Malaysian's polytechnic lecturers revealed that perceived risks and fear of the virus did not influence on the adoption of digital payment of *zakat*. Instead, factors such as convenience and useful of the digital platforms positively impacted the E-wallet usage. This finding underscores the importance

of promoting and educating the public on the effectiveness and ease of use of these platforms, as these are key factors in fostering digital transformation in ISF.

In an effort to modernize and encourage adoption of digitalise ISF, it is proposed to develop a unified and comprehensive mobile application that incorporates features of *sadaqah* contributions, automated *zakat* calculations and payments. Additionally, it is highly recommended that this mobile application to be personalized with Islamic finance educational content aims to promote financial literacy as well as financial inclusion. This inclusion includes AI-generated chatbot support in cases where users require further understanding on certain issues while assisting users on the use of the platforms. By integrating these functionalities, it aims to promote accessibility, convenience, and users' engagement in charitable activities.

Conclusion

Therefore, to improve the effectiveness of all processes involved, including the collection, management, and distribution of funds, the ISF sector should embrace the change towards digital transformation. By executing so, it can guarantee that funds are distributed to those in need in a more effective and efficient manner. This study offers a deeper understanding of the significance of this adoption. Digitalisation has provided a range of solutions to ensure system transparency and accomplish the goals of ISF, which advance economic progress and social welfare. By taking this step, ISF is able to establish accessible platforms for financial inclusion and promotes both financial and digital literacy among society. This digital transformation has demonstrated the potential to discover and fill in the gaps and opportunities in the ISF industry since its adoption helps mitigate risk in challenges faced by employing traditional ways of ISF procedures. In conclusion, digital integration into ISF is critical to reaching modern standards in the digital age, as well as to fostering national economic growth and community needs through implementation of digital solutions that complies with Shariah laws.

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