Mohamad, Saadiah; Lehner, Othmar and Khorshid, Aly. "A Case for an Islamic Social Impact Bond" *ACRN Oxford Journal of Finance and Risk Perspectives 5.2 (2016): 65-74.*

A CASE FOR AN ISLAMIC SOCIAL IMPACT BOND

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***Abstract**: While the premise of Islamic finance is often couched in the principle of maqasid al-shariah and that of risk sharing with claims to social justice and welfare, the impact and contribution to the social sector has been minimal. This paper examines the claim among critics that there is an inherent weakness of the present day Islamic banking and finance industry in terms of its underdeveloped social sector and argues for the need for new models that will enhance a proliferation of shariah compliant financial products for solutions in the social sector. This paper further examines the framework for a socially responsible investment (SRI) sukuk, launched in Malayia in 2014 and the model of SIB (social impact bond) in the social finance space to come up with recommendations for structuring a shariah compliant SIB or social sukuk.*

***Keywords**: socially responsible investment (SRI) sukuk, social impact bond (SIB), shariah compliant, Islamic finance, social finance.*

Background and Purpose

The social sector has generally been excluded in product innovations and the discourse of Islamic finance and banking industry as compared to the private or business sector and the government sector (Ismail 2014). Islamic Finance is often criticised for its lack of commitment to making a real difference for the welfare of the bottom billion in the world or the bottom 40 percent of any economy's population. Many Muslim countries are either poor or are emerging economies. For the past 30 years, the global finance industry tend to benefit the high networth individuals (HNI) and the corporate players, with limited particpation from public and limited benefits to the marginalised sector. What has developed apart from initiatives on the revival and reform of the waqf and zakat system indicate a clear lack of innovations for social objectives. Although the Islamic capital market with its impressive development in sukuk issuance does contribute to the economic and infrasructure development of many countries, and many would argue that Islamic products share the same universe with ethical investment, there is a lack of concern among Islamic financial institutions in the field of social innovations in Islamic Finance (Ismail 2014, ISRA 2009, 2012).

This paper examines the claim among critics that there is an inherent weakness of the present day Islamic banking and finance industry in terms of its underdeveloped social sector and argues for a need for new models that will enhance a proliferation of shariah compliant financial products for solutions in the social sector. It looks at developments in the social finance space and provides a case for structuring shariah compliant SIBs or what could be termed generally as social sukuk.

Islamic Finance and the Social Sector

Islamic finance is often couched in the principle of risk sharing and often with claims to social justice and welfare. However, development in the industry has been centred on profit making commercial activities in particular to the growth of products by financial institutions to raise funds for corporations and the states, with little regard to the social sector. The growth of Islamic bond or better known as sukuk for example has been responsible for much of the attention on Islamic finance. Granted sukuk issued by sovereigns and some of the supranational agencies like the Islamic Development Bank have been used to finance infrastructure development which arguably serve people at large, there are very few products which relate specifically to the social sector.

Islam calls for a comprehensive development of an economy and puts emphasis on social welfare. This comprehensive or balanced development is defined by Abbas and Askari (2010) as development in the three dimensions constituting development of the individual self, the physical development of the earth and the development of the human collectivity or the society itself. The central economic tenet in Islam is to "develop a properous, just and egalitarian economic and social structure in which all members of society irrespective of their beliefs and religous affliations could maximise their intelectual capacity, preserve and promote their wealth, and actively contribute to the economic and social developement of society" (Bennet and Iqbal 2013). These principles are enshrined in the *maqasid al- shariah* or the objectives of shariah or Islamic Law. The overriding objective is to preserve the public good or *maslahah.* The objectives of the shariah is to promote the well being of all mankind, which lies in safeguuarding their faith (din), their human self (nafs), their intelect (aql), their posterity (nasl) and their wealth (mal). Whatever ensures the safeguard of these five serves the public interest and is considered desirable (Dusuki and Abdullah, 2007).

Theoretical, philosophical as well as historical analysis of Islam places importance in its contribution to the social sector. Discourses on Islamic Finance particularly in relation to the issue of form and substance and the discourse on *maqasid al shariah* (objectives of shariah) points to an important aspect of value proposition of Islamic financial products. The shariah compliance should satisfy the "legalistic form" and should embed some minimum standards of "substance". Discourses on the *maqasid al shariah* provide ample discussion and emphasis on issues of equity and fairness in Islam (Kamali 2006). It is also in the spirit of the *maqasid* that the industry should be inclusive, and that it considers justice and the well being of the society at large as sacred. Thus, it can be argued that shariah compliant products, unlike the conventional instruments, by virtue of it being shariah compliant in its form must have embedded in it the "substance" where social and ethical values are incorporated in the structuring and distribution of the products. However, in reality the existing shariah products in the market, both in terms of the quality and the range of products are still far from serving the higher objectives of the shariah.

Why then has there not been much more contribution from the Islamic finance industry to the social sector ? Islamic finance industry has been centred very much on the development of shariah compliant products, mimicking conventional products which are available in the market by making them to meet requirements of the prohibitions on riba, and other prohibitions such as gambling, excessive speculation and uncertainty by adopting the various legal contracts allowed in Islam. Over the years the Islamic finance industry appears to have been overly technical and legalistic, a focus on the "form" rather than "substance". Bennet and Iqbal (2013), argues that traditionally Islamic finance has relied on negative screening. Shariah compliant equity funds for example, have grown significantly through screening and filtering of stocks of businesses according to a set of rules that screen out prohibited activities such as funds that are involved in gambling and alcohol. On the fixed income side of the market, the negative screening has been the pre dominant strategy. While negative screening ensures investors that the money they invested is not used to support investment that is prohibited by Islam, these investors are not given the opportunity to affirm their belief in a more positive manner, that is to pro actively direct investment to areas which have important impacts from the maqasid shariah point of view.

Bennet and Iqbal (2013) argues that the lack of supply of such products is largely a result of a lack of clearly expressed demand from investors. But would investors be sophisticated enough to be demanding such social impact products? Argueably much development in the industry has been supply led. In a country like Malaysia where development in Islamic Finance has received a lot of government support, the market has been seen to be supply led through initiatives from state organisations like Khazanah Nasional which in its attempt to propel Malaysia as a global market leader, has issued many land mark sukuks. Following the 2014 Malaysian Securities Commission issuance of the first guideline on SRI sukuk, Khazanah Nasional Berhad in June 2015 has issued the Ihsan sukuk which is Malaysia first SRI sukuk, and possibily the world's the first SRI sukuk raised to finance education. For much of the time though, due to a shortage in the supply of shariah compliant products in the market, the industry is rather complacent, because it appears that whatever is supplied in the market, is taken by investors, and in many instances of sukuk issuances, these are heavily oversubscribed. So unless there is more commitment on the supply side to have more investment in providing the transition from negative screening to positive screening to allow the chanelling of investment funds into areas that embrace the concept of maqasid shariah, Islamic finance is still far away from being through to its spirit.

There is a proven track record in Islamic history pertaining to financing the social sector for example using tools of *zakat* (mandatory alms giving) *sadaqa* (voluntary alms or charity) and *waqf* (perpetual endowment). Adam Ng et. al (2015) for example argue that the proven track record in the development of public facilities and services in the past is testament to the significant and long term beneficial effects that a well-designed waqf system can have on a country's moral, social, economic and political landscape. [1]

Since the social sector has been funded through these social tools, a greater part of the public services have been funded by the social sector for the social sector. This has meant reduced burden on the part of the government to raise for public spending. However, at various times in history, zakat and waqf have also been institutionalised to improve its working and efficiency. Later, the shift from the social sector to the government sector, by adding beaucracy and removing the flexibility of the system, and the coming of colonial intervention in these muslim countries contributed to the downfall of the zakat and waqf system world wide. In some countries, like Turkey and Egypt vestiges of the old system continue to exist. And in countries like Malaysia and Singapore, there are attempts at reviving the old system and using the concept to build more innovative ways to solve social issues.

[1] Notable examples funded under waqf include public services in Muslim Ottoman cities, Dar al Hikmah (abode of Wisdom), built by the Fatimid Caliph al hakim in the eleventh century, Madrasah Nizamiyah in Baghdad, al Qarawiyyin in Fez, University Al Azhar in Egypt recognised as the oldest university in the world, University of Cordova in Spain, Universitas Islam in Indonesia, Shishli Children Hospital in Istanbul and Al Noori Hospital in Damascus (Makdisi, 1982 and Kamali 2014 as cited in Ng 2015 pp 180 notes no.19)

Provision of Public and Merit Goods

Both the government and the private sector has a role to play in the social welfare sector, particularly in the collection and mobilisation of funds towards development of what economists term as public and merit goods. Public goods are goods and services where distribution through price mechanism is not possible or cumbersome such as in the classic case of street lighting or public safety. Merit goods are those with positive externality such as education and health, where because of its obvious benefits to society as a whole, the provision of these goods and services should be subsidized by the government because the level of production of these goods in the economy by the private sector is not *pareto* optimal.

While it is true that there is an improved system in terms of zakat collection and to some extent that of waqf in countries such as Malaysia to complement the market on the provision of public and merit or social goods, this is mainly done by government agencies with very little participation from the private sector. Islamic civilisations such as that of the Andalusian Spain and the Ottomans have had rich history whereby the social welfare sector was highly developed by the contribution from waqf much more than by the government funding (Cizakca 1998).

Outside the Islamic space, we notice developments in social finance and social entrepreneurship that illustrate an increasing interest globally to look at alternative ways of creating values and empowering the community and society at large. There has been interesting innovations and thought processes including developments in social impact bonds, green bonds, ethical investment, crowd funding, social entrepreneurship, inclusive growth, growth with distribution, sustainable development and etc. These ideas and concepts reflect serious thinking which challenge the philosophy of the mainstream economic development and the rise of economic financialisation which tends to benefit the private and the government sector at the expense of the social sector.

In making a value proposition, Islamic Finance could provide a difference not just to the HNI (High Networth Individuals), the sovereigns and the big corporate players, but that it could expand and be diffused in the social fabric of the society, much like the waqf based social and economic activities during the Ottoman and Spain Islamic civilisations; where the basis of sharia law was applied to serve the social sector and benefited people at large regardless of religious affliations.

Innovations in Social Finance (Lehner 2013, 2014) and social entrepreneurship (Nicholls 2008) provide the timely climate and landscape to spur the development of more shariah compliant financial instruments combining financial and social returns, that at the same time help expand the universe for Islamic products. Product proliferation especially in the social sector and the development of new business models of the traditional waqf and zakat sector being much needed by the Islamic finance industry, will attract new Islamic investors including ethical investors, philanthropists and institutional investors with social mandates. This transformation increases the social investor base that will help promote social capital, growth with distribution and social stability.

The way forward is for Islamic finance to play a much bigger role to enhance the development of the third sector by empowering and mobilising the social sector itself with active support from the government and the private sector. In particular, Islamic finance both as an academic discipline and as an industry can expand its frontiers of knowledge and the universe of shariah compliant products by developing more innovative instruments that provide solutions to social problems and promote social welfare inspired by its own rich Islamic tradition and the emerging innovations in social finance. With an enhanced third sector, an Islamic economic model will be more comprehensive and holistic and not lopsided with the social sector lagging behind the other two sectors of the government and the private sector. Islamic finance as part of the more comprehensive Islamic economy could thus become relevant and be contributing to the general maintenance of social services of an economy, a role that goes beyond race and religion.

Development in Social Impact Bonds (SIBs)

Shifting systems and ongoing dynamics of social welfare provision, including severe cut backs in public expenditures, are transforming traditional ways of funding social services (Karanikolos et. al, 2013; Vis, Kersbergen & Hylands, 2011; Wilson, K. E., Silva, F., & Ricardson, D. 2015).

Especially in liberal states (Esping-Anderson, 2006), public bodies are more and more turning to - and encouraging - private organizations, either from the third sector or from the commercial sector in form of social enterprises, to target social needs and problems that otherwise would not be tackled. As Allen (2009) and Millar (2012) point out, amongst the reasons for this development may be an alleged higher efficiency and perhaps effectiveness of the private sector with their more narrow focus compared to their public counterparts. As a seemingly perfect instrument to a) encourage and fund social enterprises and b) ensure efficiency and effectiveness, social impact bonds have been created in various shapes and sizes (Fox & Albertson, 2011, Glänzel et. al. 2015, Lehner & Nicholls, 2014).

A SIB can thus be considered as a new type of public-private partnership aiming to provide social services, as well as a funding mechanism (Jackson, 2013; Nicholls & Tomkinson, 2013). Inherent in the SIB's contractual arrangements are evaluation mechanisms and performance indicators, measuring the outcome of the service delivery. While in literature such outcome metrics are still highly disputed, they are demanded for by investors and decision-makers in practice (Yen, 2015). Warner (2013) alongside Liebman (2011) describes SIBs as hybrid instruments with elements of both, equity and debt. The actual classification is based on the contractual arrangements concerning risks, returns, subordination in the case of liquidation, and implied ownership rights.

A government commissioner works with a private financing intermediary, which agrees to raise (for example from social banks, impact investment funds, venture philanthropists, or Big Society Capital in the UK) investment capital and provide up front financing to the social venture. As a first step, these intermediaries take care of the screening and due diligence of the fund-seeking venture. What can be seen from first empirical evidence is that a proven track record of social service delivery can be regarded as a very strong signal in this screening process. While there is a certain logic to it, it also discriminates against new market entries with innovative ideas – yet such entrepreneurial ideas are one of the central promises of the governmental outsourcing process. It seems that the rationale of the intermediaries are perhaps increasing efficiency, but perhaps at the cost of innovation.

Based on the level of achievement of the contractually agreed social outcomes (often in a staggered form), the commissioner pays back the principal to the intermediary, who in-turn reimburses the investors - the actual sum ranging from just the nominal up to the inclusion of a certain interest, which in most cases is still sub-par compared to the implied (and still poorly understood) risks. Upon failure to deliver, the principal itself is at stake. An independent assessor is commissioned to assess and report on the targeted outcomes.

As can easily be derived from this description, the setup of a SIB is a very complex endeavor that includes a multitude of involved players who find it increasingly difficult to find a common ground as their motivations fundamentally differ based on their role in this setup. What is even more aggravating is the additional pressure of finding and agreeing on a suitable metric to assess the outcome of an often complex and dynamic societal intervention (Butcher, 2015, Dagher, 2013; Fox & Albertson, 2012; Lehner & Nicholls, 2014; Liebman, 2013; Ragin & Palandjian, 2013; Warner, 2013).

Despite this complex setup, many countries are already embracing the concept based on its implied promises. This is rather remarkable as so far most SIBs in the UK have failed for various reasons, including the pilot SIB, the Peterborough SIB (Disley and Rubin 2015, Nicholls and Tompkinson 2013; Wilson et. al. 2015), which failed to reach its target in the first years and was closed early in 2015 due to external changes.

Social bonds are an innovative way for private and not for profit organisations to partner in delivering better social outcomes, and be rewarded by government. Social bonds see private and not for profit organisations partner to fund and deliver services to improve social outcomes. If they achieve agreed results – the government will pay the investors back their investment plus a return. Investor returns depend on the level of results, up to an agreed maximum. (for a pilot study in New Zealand see http://www.health.govt.nz/ourwork/preventative-health-wellness/social-bonds-new-zealand-pilot). In this model, at least four parties are involved:

1. *Service providers* who deliver the social services
2. *The investors* which could be retail or institutional provide upfront funding to service providers ,
3. *An intermediary* assists with raising funding and driving service performance
4. *Independent assessors* review and verify results.

The first social bond launched in 2010 is the Peterborough Social Impact Bond , UK provides funding for a programme aiming to reduce the rate of reoffending among prisoners serving short sentences at Peterborough prison. Data released in October 2013 suggest 12 per cent decline in reconvictions amongst programme participants compared with a 11 per cent increase in reconvictions for similar ex-prisoners nationally. The New York City Social Impact Bond, launched in 2012, which raised USD$9.6m capital to finance a programme also aimed at reducing reoffending among adolescent offenders at Rikers Island correctional facility. If successful, depending on the reductions in re-incarceration rates achieved, the City is expected to gain net savings of between USD$1m and USD$20m.Another social bond The Newpin Social Benefit Bond, launched in New South Wales in March 2013, has raised AUD$7m capital for a parenting programme to restore children in out-of-home care to their families, and prevent at-risk children from entering care. This programme is expected to generate savings of AUD$80m if the targeted level of child restorations is achieved. (http://www.health.govt.nz/our-work/preventative-health-wellness/social-bondsnew-zealand-pilot).

These projects certainly are important innovations that attract global attention because they have the potential of becoming powerful tools as social solutions in our society. The social sector everywhere seems to lack funding and with governments in many countries having huge debt problems, these solutions should be welcome everywhere. Social bonds are slightly different from socially responsible investment SRI but they might overlap. Although both have social impacts, social bonds represent not the usual model of financing a business venture with concerns on the social or environmental impacts. Social bonds are a totally new way of government contracting, viewing solutions to social problems as opportunities for society to solve and in the end be rewarded with its success.

Structuring a Social Impact Sukuk

Islamic financial industry is largely known for its prohibition on interest or riba but the ethical and and socially responsible dimension of the system is often ignored. There is a large potential that can be leveraged to increase the universe of Islamic finance by exploring this SRI space. Some of the benefits that can be put forward to justify the development of the social sukuk are the following:

1. *Provides sustainable funding*

SIBs would provide for sufficient and sustainable funding for social projects including those projects which might otherwise not got off the ground because of high risks or limited amount of funding and resources either from the government or the third sector. The SIB model provides the scale that may not have been provided under traditional models of state funding or reliance on charities and donations from the third sector as the funds may be sporadic or takes too long to reach a critical amount sufficient for a project to take off. SIBs can be structured with a long term view and can be launched in tranches to ensure smooth rolling of project funding.

2. *Promotes risk sharing among stakeholders*

The SIB model promotes risk sharing between the various stakeholders across important sectors of an economy which are the public, the private and the third sector. As risks are shared, each stakeholder would bear a smaller risk compared to if the project or provision of social service were to be provided by a single provider. This model reduces risks that would be shouldered by a government where under a conventional model the government bears all the costs and risks of providing the country's public goods and many of the merit goods. Such reduction of risks and public spending not only could reduce government debt but also benefit tax payers and society at large when such cost savings could be translated into lower tax and greater provision of public and social goods.

3. *A collaborative stakeholder model that enhances efficiency*

The model enhances multi stakeholder collaboration by aligning incentives among stakeholders and focusing on result oriented objectives. Such alignment can promote efficiency and cross sector connectedness among the government, philanthropy, investor and social actors (Ng et. Al 2015). In such a collaborative ecosystem, initiatives and projects have outcomes which are clearly defined, and success is measured and rewarded. This raises accountability of stakeholders, reduces costs and likelihood of success and expectantly tendencies for misuse of funds, fraud and corruption.

4. *Spur innovation for social solutions*

SIBs can be used as tools to help raise finance for innovative ways to provide solutions to social problems and minimise harm brought about by these problems. These issues could be youth unemployment, drug addiction, teenage pregnancy, youth delinquency, gender discrimination, rising crime rate, and etc. Inadequacy of basic facilities are often linked with low social capital and presence of social problems and the complexity of issues of problems calls for a more innovative and integrated approach to solving these problems. The NGOs and charity organisations which have been working in social programs could now have access to better funding if SIBs could be used as a platform to bring the various stakeholders together to solve some of the most critical and complex issues in the community.

5. *An alternative asset class for investment*

Securitization of social programs whose performance is driven by measurable social outcomes represents a new alternative investment asset class that has low correlation to the conventional markets (Ng et.al 2015). SIBs are expected to be less subject to market volatility due to macroeconomic shocks, business cycles or market behavior. New products in the Islamic investment space are much welcome for capital market deepening in a space where supply and opportunities for portfolio diversification is still limited. Shariah compliant SIB enables more efficient use of charity/waqf/donation/endowment funds, and possibly new ways of raising funds through crowd funding by appealing to the general masses.

Due to the potential of huge benefits and that social bonds seem to be in line with *maqasid al shariah*, governments, supranational agencies and charity organisations could work with the Islamic finance community to identify areas where social sukuk could be developed to provide financing solutions for some of the social issues in the community. These could range from poverty alleviation, illiteracy, drug addictions, teenage pregnancy, crime and theft to flood mitigations and relief work are issues that require new approaches which can provide more efficient solutions to the use of government funding.

Structuring a social bond requires careful identification of a desired social outcome. However turning it into a shariah compliant product may raise shariah issues that require careful investigation and coming up with a shariah resolution. For example, if the social sukuk is to be structured, what is the underlying asset and what kind of Islamic contract that can be used here? Is it acceptable that the delivery of a social service outcome be turned into a financial product that gives returns when social projects could simply be financed using the traditional sadaqa or charity funds? An obvious motivation is that a financial instrument like bonds or sukuk could offer a more productive and efficient way of using government or sadaqa and endowment funds because success outcomes are carefully defined, measured and rewarded.

Conclusion

This paper argues that the Islamic finance industry suffers from an underdeveloped social sector that prevents it from really embracing the concept of the maqasid al shariah which upholds the principle of serving the public interest of maximising benefit and reducing harm. A lop sided development which ignores the social welfare is thus not in the public interest. Eventhough supply side could be made to be more responsive if investors are sophisticated enough to demand more SRI or social impact type of products, the paper recommends that growth in this space within Islamic finance should be supply led. Due to the huge potential of the shariah social impact space, the paper recommends for indentification of areas where products such as shariah compliant SIB or social sukuk could be structured. There are currently only two globally recognised SRI products in the Islamic universe: the 2015 Malaysian SRI sukuk, and the sukuk launched by the International Finance Facility for immunisation which raised US 4500 million for children’s immunisation in the world’s poorest countries. There are a lot of benefits that can be reaped from such development, one is that of bridging the conventional space with Islamic finance but more importantly the growth of social impact products within the Islamic space would strenghten social capital and brings it closer to the true spirit of Islamic finance of maximising social benefits and reducing harm.

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