

SOCIAL IMPACT BONDS: A SHARĪ‘AH POINT OF VIEW

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I. INTRODUCTION

A new financing instrument for social projects has recently emerged that impacts directly or indirectly on the underprivileged segment of the society. It is known in the United Kingdom (UK) as ‘social impact bonds’ (SIBs); in Australia as ‘social benefit bonds’ (SBB); and in the United States (US) as ‘pay for success bonds’. These names were coined because of the nature of the bonds; they are used to finance projects that have social impact, and the commissioner of the project only pays if the outcome meets the agreed target; otherwise, investors will lose their investments, including the principal and profit. This paper will hereon use the term SIBs as it is the most popular designation as well as the original one.

SIBs were developed to finance underserved social projects in the aftermath of the 2008 global financial meltdown, as many governments started to search for cheaper means of financing to reduce pressure on public finances. The first SIB was introduced in 2010 by Social Finance UK to finance the Peterborough prisoners’ reintegration programme (Davies, 2014). The project was, however, terminated by the government without allowing the service provider to reach the target. Despite this premature termination, the instrument continued to gain acceptance and popularity across the globe. SIBs have been issued in Europe, the US, Australia, Israel and Africa, with successful results reported (Gustafsson-Wright & Gardiner, 2016). As at 2016, about 40 such bonds have been issued worldwide (New South Wales Government, 2016).

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Despite the widespread and manifest advantages of SIBs, there are some who criticize them, arguing that the contract structure of SIBs involves a high level of inherent uncertainty and that, the project manager may cherry-pick candidates of obvious positive outcomes (Edwards, n.d.). Nevertheless, SIBs have rapidly spread across the globe within just six years of their inception and have attracted the growing interest of state and national governments as well as not-for-profit organisations (NFPOs). These are indications of the potential the new social financing system holds for society. It is important to note that despite the name, 'bonds' in SIBs, they are not debt instruments like the conventional bonds and debentures, but a mere fundraising mechanism (Liebman & Sellman, 2013; Canadian Union of Public Employees, 2016). On the Islamic finance front, contemporary Sharī'ah scholars have yet to issue a formal fatwa (legal opinion) stating the Sharī'ah status of this social projects funding mechanism. The question thus arises whether the contract formation of SIBs is in line with the principles of the Sharī'ah. The aim of this article is to delve into this issue and provide a brief Sharī'ah analysis on SIBs.

II. DEFINITION OF SIBs

SIBs are conventionally defined as “a financing mechanism for social outcomes where investors provide upfront capital for services, and a government agency repays investors contingent on outcome achievement” (Gustafsson-Wright & Gardiner, 2016). According to Goldman Sachs (2014), they represent “a public-private partnership designed to deliver ambitious social programmes to underserved communities”. Greater detail is provided by Social Finance UK (2016) which describe it as:

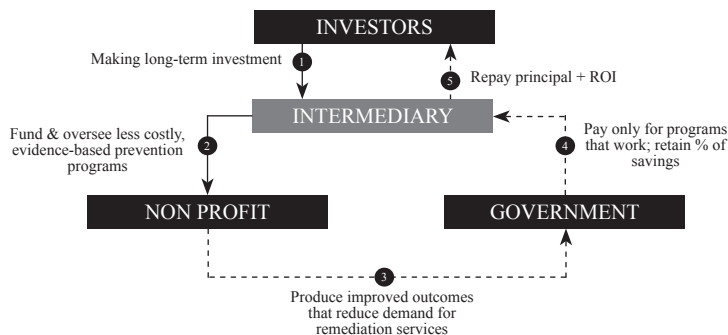
a financial mechanism in which investors pay for a set of interventions to improve a social outcome that is of financial interest to a government commissioner. If the social outcome improves, the government commissioner repays the investors for their initial investment plus a return for the financial risks they took. If the social outcomes do not improve above an agreed threshold, the investors stand to lose their investment (Social Finance UK, 2016).

SIB investors generally invest in community projects which elicit sympathy and empathy, involving issues such as unemployment, recidivism, poverty, homelessness and domestic violence (Social Finance UK, 2016). The capital is provided up-front by investors while the return is from the government, not the investee, if certain targets are met. SIBs' profitability is, however, uncertain as investors are not sure of getting their principal repaid or receiving the expected profit.

III. FORMATS OF ISSUANCE OF SIBs

Generally, SIBs are issued by non-governmental organisations (NGOs) or not-for-profit organisations (NFPOs) that have a mandate to provide community services, or any other institution permitted by the authority to carry out the business of SIBs. The issuance structure normally consists of the following parties: the outcome funder, which is the government (national or regional); the project manager, which is normally an NFPO (it may need to engage the specific service provider); an intermediary in the form of a special purpose vehicle (SPV); and the social beneficiaries (Gustafsson-Wright & Gardiner, 2016). In some structures, an independent evaluator may be appointed to assess the outcome and determine whether the project manager and the investors are entitled to repayment of principal and profit/interest (Gustafsson-Wright & Gardiner, 2016). Figure 1 depicts the structure of SIBs.

Figure 1: Structure of SIBs



Source: Forbes (2014) in Cassie (n.d.)

The structure flow is as follows:

1. Investors pay an investment amount to an intermediary (it is also referred to as the project manager in the context of SIBs).
2. A not-for-profit organisation (in this context it is the service provider) receives funding from the intermediary (mostly an NFPO also).
3. The NFPO provides a social service designated by government or its commissioner.
4. Government pays the intermediary for the outcomes that are certified to have met certain metrics while retaining some percentages (the difference between the entitlement of SIBs' investors and the cost of traditional public project).
5. The intermediary repays the investors the principal and return on investment (usually in the form of profit).

IV. THE ISLAMIC VIEWPOINT ON SIBs

To derive an Islamic viewpoint on SIBs it is pertinent to examine some nominate Islamic contracts that share some resemblance with SIBs. Some of the arising issues in SIBs are also discussed below.

- a. **Gharar (Uncertainty).** The current structure of SIBs involves the government awarding a social project to an NFPO and promising to pay if the latter meets the target; if the NFPO could not meet the target, there will be no payment. The uncertainty in the payment of the principal and profit/interest makes the element of *gharar* in the contract substantial. In Islamic finance, the element of excessive *gharar* invalidates an exchange contract, based on the Prophet's (peace be upon him) prohibition of the sale involving *gharar* (Muslim, n.d.).

It can be argued, however, that the willingness of investors in SIBs to engage in a contract that may not even return their capital tends to support the argument that their primary intention is community service and philanthropy. Given the

nature of the risk and the payout, the intention of engaging in an exchange contract, in which the objective is to maximise returns, can only be secondary. No rational investor would invest his money in a project that he knows from the outset will involve loss of his principal if the stipulated target is not met. This means that the social investors are not prioritising profit or interest in SIBs, and this is further supported by the domination of the market by NFPOs and philanthropists as issuers of such bonds.

Based on this argument, it can be said that the *gharar* that arises in SIBs—whether minimal in nature or not—is not considered an invalidating factor because the investors are not focused on getting profit from the contract. Rather, they are social investors with a distinct philanthropic trait seeking satisfaction from community investments and community service. The contract would, therefore, fall within the category of charitable contracts wherein the issue of *gharar* would not invalidate the contract.

- b. ***Hibat al-thawāb* (Gift with expected compensation).** This term refers to a gift given with the intent of getting compensated by the receiver with something similar to or better than the gift. This act is permissible in the Mālikī school in concurrence with Ibn ‘Abbās’ interpretation of the word *ribā* (interest) in Sūrah al-Rūm: “Whatever you lend out in interest to gain value through other people’s wealth will not increase in Allah’s sight, but whatever you give in charity, in your desire for Allah’s approval, will earn multiple rewards” (Qur’ān, 30: 39). The *ribā* that is mentioned in this verse was interpreted by Ibn ‘Abbās to be *hibat al-thawāb* and he ruled that it is permissible (Ibn Kathīr & al-Dimashqī, 1999).

The similarity between SIBs and *hibat al-thawāb* is that both contracts have some elements of gratuity and some of exchange. While the gratuitous nature of *hibat al-thawāb* is clear, it may be less so in SIBs. Below are the arguments that establish the presence of the element of gratuity in SIBs:

1. NFPOs are usually and predominantly the project managers of SIBs and it is known that their work pertains to community service.
2. The social projects that the government licenses SIBs' project managers to undertake are projects that they would have still wanted to discharge voluntarily based on the objectives of their organisations.
3. Most investors in SIBs are philanthropic investors whose investment appetite stems from the love of contributing to community development.
4. Philanthropic investors who invest in SIBs agree to use their savings to serve the community based on an unguaranteed return of principal and profit. Their permission is evidence that they are pleased with any outcome of the investment, considering that they will gain satisfaction through community service.

Based on the above arguments, it can be concluded that SIBs are akin to *hibat al-thawāb*. Moreover, under *hibat al-thawāb* return of principal and even profit is deemed permissible. It can thus be argued that the NFPOs that issue SIBs would deserve repayment of at least their principal from the government/commissioner. Moreover, if any premium were paid by the government/commissioner, it would be regarded as compensation in the form of *hibat al-thawāb* and would not be deemed *ribā*.

- c. ***Ja'ālah* (Unilateral contract made to another person, but payment consideration is anchored on performing the contracted task).** Another contract that resembles the contract underlying SIBs is that of *ja'ālah*. *Ja'ālah* is a unilaterally commissioned contract without mutuality in the terms of the contract. Anybody that subscribes to the contract is prone to profit or loss, the loss being at his peril; but if he succeeds he is entitled to receive the promised reward. The commissioner is not responsible for any loss of time and resources. However, the task and the consideration must be made clear, and the

conditions must not be unrealisable by human reasoning (Alaysh, 1989; Ibn Rushd, 2004). The contract of *ja'alah* is tainted with excessive *gharar* as the probability of success is roughly balanced with the probability of failure. Likewise, under SIBs, the probability of success is roughly balanced with that of failure. The contract is thus tainted with *gharar* as in *ja'alah*, which is nevertheless permitted by classical jurists (Alaysh, 1989; Ibn Rushd, 2004).

- d. **Maysir (Gambling).** Gambling is prohibited in Sharī'ah by virtue of the Qur'ān (5: 90). However, it is difficult to equate SIBs' operational mode to gambling because gambling occurs when two or more persons commit their money for a competition in which the winner takes the entire stake. That is, the winner benefits at the expense of his opponent.

In SIBs it is clear that the intention of the NFPOs and investors is to contribute to community development and get compensation from the government. The projects financed by SIBs do not belong to a particular government official, and the beneficiaries of projects financed by SIBs are the grass roots of the society who do not contribute to the development of the projects nor do they enter into any contract with the service providers. Therefore, the conditions of gambling are not applicable to SIBs (al-Azhari, 2001).

V. A SHARĪ'AH ANALYSIS OF SIBs

Having presented the theoretical framework, the structure of SIBs and the Islamic contracts that share some resemblance with SIBs, the determination of the Sharī'ah position on SIBs hereby ensues.

Based on the foregoing discussion, it is noted that there exists a contractual relationship among the four stakeholders involved in the issuance of SIBs, in varying degree of enforceability of their attendant obligations. Between the investors and the intermediary, there is a relationship of *wakālah* (agency contract). The relationship between the intermediary and the NFPO (in its capacity as service provider) is one of *musta'jir* and *ajir* (employer-employee relationship). The

intermediary is also acting as a trustee on behalf of the government in ensuring service quality. Whereas, on the aspect of the relationship between the government and the investors, in the opinion of the author, there seems no actual nor constructive relationship. This is because there is no contractual terms between the investors and the government as seen in Figure 1, and consequently, they cannot sue the government for any contractual obligation.

Based on the above argument, the researcher concludes that SIBs is a typical philanthropic investment. Thus, *qiyās al-shabah* (analogy based on shared resemblance between two original cases and not based on effective cause) is invoked. An example where such *qiyas* will apply is in the case of a slave. A slave shares resemblance between humans and domestic animals as he could be taken to market and be sold like an animal (see, Ibn 'anal, 1999).

VI. FINDINGS AND CONCLUSION

The paper considers SIBs as an alternative instrument for funding social projects that are of public interest. The instrument, being new and emergent, is deemed important and useful to the less privileged members of the society. However, the concern of this paper is about the Sharī'ah status of this instrument—whether it is acceptable from the Sharī'ah point of view or not. This is because the contractual agreement underlying SIBs apparently contains excessive *gharar*. Despite the element of *gharar*, the findings of this paper show that, generally, the payment arrangement of SIBs involving 'pay for success' is not against the Sharī'ah if all the contracting parties consented to the arrangement. This is because in Islamic jurisprudence, not every contract that contains *gharar* is deemed Sharī'ah non-compliant, as in the case of *ja'ālah*. This permissibility, however, does not include involvement of for-profit organisations as investors. Here, the actual terms of the contract of commissioning and project delivery must apply, and the project manager, whether a for-profit organisation or an NFPO, is entitled to the amount mutually agreed to, without the need to specify the principal and what constitutes his profit. Under the Shari'ah, SIBs should be called Social Impact *Ṣukūk* (SIS). More research is, however, still needed to deliberate further on the subject.

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