Risk Sharing and Social Impact Partnerships by Dr Adam Ng

SC-OCIS
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SC-OCIS Scholar-in-Residence Programme

The collaboration between the Securities Commission Malaysia (SC) and Oxford Centre for Islamic Studies (OCIS), UK was established in 2010, with the objective of promoting intellectual discourse and research on applied and contemporary issues with respect to global Islamic finance.

The SC-OCIS Scholar-in-Residence programme is one of the outcomes aimed to pursue further research that complements the flagship programme which is the annual SC-OCIS Roundtable. A thought-leadership platform, the SC-OCIS Roundtable gathers distinguished scholars, academicians, regulators and Islamic finance practitioners to discuss and exchange views on contemporary issues in Islamic finance.

Dr Adam Ng from the International Centre of Education in Islamic Finance (INCEIF) was the third Visiting Fellow of the SC-OCIS Scholar-in-Residence Programme for the academic year 2014/2015.

During his tenure, Dr Adam completed a research on "Risk Sharing and Social Impact Partnerships". His research articulates a business model that brings social capital and risk sharing into renewed focus to create the demonstration effect which could bring about a global impact. The Islamic concept of risk sharing may curb speculative risk shifting and result in greater financial stability with the intent of creating a more stable and accessible financial markets. The research also provides a novel discussion of various Islamic financial structures such as risk-sharing sukuk, social impact bonds and *waqf* to facilitate greater access to markets and induce more equitable and sustainable economic growth.

It is hoped that Dr Adam Ng's research will help to promote a greater role for risk-sharing in Islamic finance to be differentiated from and avoid the drawbacks prevalent in debt-based financing.

Profile of Scholar

DR ADAM NG
SC-OCIS Scholar-in-Residence in Islamic Finance 2014/2015

Adam Ng is Assistant Professor at the International Centre for Education in Islamic Finance (INCEIF) and Fellow at the London-based Royal Society of Arts. Recently, he conducted the General Council for Islamic Banks and Financial Institutions (CIBAFI)'s Global Islamic Bankers' Survey 2016, covering the responsible business and sustainability practices of 86 banks from 29 countries.

He also developed a Sustainability Strategy, Financing and Valuation Framework for a regional bank, and collaborated with the Central Bank of the Republic of Turkey on a research concerning Islamic banking for small-medium enterprises (SMEs) in Turkey.

A co-author of a book, *Social Capital and Risk Sharing: An Islamic Finance Paradigm*, his research has been published in journals such as *Renewable and Sustainable Energy Reviews, Energy Economics, and Economic Modelling*. Adam was Research Associate at the Oxford's Global Economic Governance Programme (2015-2016) and Securities Commission Malaysia-Oxford Centre for Islamic Studies Scholar-in-Residence in Islamic Finance (2014-2015).

During his service at the Bank Negara Malaysia, he contributed to strategic initiatives in Islamic financial infrastructure development and central banking collaboration, principally the establishment of International Islamic Liquidity Management Corporation in 2010. He served in the pioneering team of the newly established supranational institution formed by 12 central banks and one multilateral development banking group, and laid the foundation for the issuance of the world's first A-1 rated US dollar short-term sukuk.

He received his PhD in Islamic Finance from INCEIF as a Bank Negara Malaysia's Shariah scholarship holder and Bachelor of Civil Law from University of Oxford with Lincoln College's Sloan Robinson Foundation Graduate and Supperstone Law Scholarship awards.

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Risk Sharing and Social Impact Partnerships

by Dr Adam Ng

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Shariah scholars and Muslim economists who participated in the Second Strategic Roundtable Discussion (September 20, 2012, Kuala Lumpur) sponsored by the International Shari'ah Research Academy for Islamic Finance (ISRA), the Islamic Research and Training Institute of the Islamic Development Bank Group (IRTI), and Durham University adopted a final statement known as the Kuala Lumpur Declaration. The statement argued that risk sharing is the essence of Islamic finance. It recommended that (i) governments must endeavor to enhance risk-sharing systems by levelling the playing field between equity and debt;[1] (ii) design fiscal and monetary policies based on risk sharing; (iii) issue macro-market instruments that are of low denominations, sold on the retail market and supported by strong governance oversight; and (iv) broaden the organizational structures beyond traditional banking models to formats such as venture capital and *waqf* to meet the social goals and risk sharing features of Islamic finance.

Effectively, the adoption and implementation of these recommendations can further strengthen social solidarity and cooperation, promote better governance, and build trust in the economic and social system. This chapter focuses on the design and development of risk-sharing instruments pursuant to the third and fourth recommendations of the Kuala Lumpur Declaration. With regard to macro-market instruments, this chapter highlights their benefits to the society and the economy, followed by a discussion on the mechanisms and ways in which these instruments can be developed. On the broadening of structures beyond traditional banking models, this chapter draws insights from the development of social impact partnerships in the United Kingdom and the United States and discusses its relevance to the Islamic finance industry and the *waqf* sector. The overall thesis is that macro-market

[1] This can be done by "removing all legal, administrative, economic, financial, and regulatory biases that favor debt and place equity holdings at a disadvantage" (Askari et al., 2011, p. 122).

participation instruments and social impact partnerships are closely aligned with risk sharing and promote social causes to the extent that they can strengthen social capital in the community.

Financing Government's Budget through Macro-market Participation Instruments

A study by Reinhart and Rogoff (2009) suggested that all "currency" or "banking" crises of the past have been, at their core, debt crises. In a more recent study of 44 countries over a 200-year period, Reinhart and Rogoff (2010) concluded that the growth of economies comes under stress when debt-to-GDP ratio is above 30 percent. As the ratio surpasses 90 percent and goes beyond 100 percent, economic growth suffers significantly and an economy can grow to an extent that only allows it to service its debt. While some methodological questions have been raised on this taxonomy of this study, the overall thesis of Reinhart and Rogoff that large debt creates a drag on the economy remains valid. With the stock of debt significant larger than GDP and the rate of growth of GDP far less than the rate of interest, it is difficult to envisage how the world's productive capacity can validate this mountain of debt and prevent debt-induced crises.

Recently, Thomas Piketty (2014) has drawn attention to the disastrous consequences of the dynamics of sizable positive differences between the rate of interest and the growth of GDP for income and wealth inequalities. It has long been known that large inequality erodes social solidarity, trust, and social capital. Growth in household debt is no less damaging than the growth of government debt. Drawing on evidence from the United States and international data, Atif Mian and Amir Sufi (2014) reveal in *House of Debt* that "economic disasters are almost always preceded by a large increase in household debt" (p. 17). A heavily debt-based financial system concentrates risk and losses on the debtors

and homeowners, resulting in spending cuts and unemployment. The previous and current policies have been heavily biased toward protecting banks and creditors, which have dramatically increased the flow of credit that brings with it disastrous counterproductive consequences. These risk transfer and risk-shifting policies with interest rate-based instruments erode the fabric of the economy and weaken the social capital of society, resulting in financial regime uncertainty and loss of collective welfare. The search is on for an alternative in which risk sharing can serve as an efficient replacement for the current regime (Mirakhor *et al*., 2012). A risk-sharing system would serve the true function of finance as the faithful facilitator of real sector activities and would avoid the emergence of what James Tobin labelled a "paper economy" where finance is decoupled from the real sector (Tobin, 1984; Askari *et al*., 2011). The risks of adding value to the economy are thus shared between finance and real production.

Over the past two decades, there has been call for the development of "macro-market" instruments that could promote collective and individual risk sharing. These instruments can be developed within each country, to be traded globally in the capital markets to diversify individual country's exposure to income and macroeconomic shocks and to enable consumption smoothing (see also Borensztein and Mauro, 2004). Shiller (1993, 2003), the first to suggest this kind of instruments, considers that the advantages and potential of risk sharing are significant but have yet to materialize. This leads to substantial loss of welfare, constraining productive activities. Reasons for this failure of adoption of risk sharing are said to be informational problems, lack of policy commitment and credibility, weak governance, international contract enforceability issues, and moral hazard. In well-functioning free-market economies, characterized by complete contingent markets or with complete Arrow securities, risk would be optimally shared among participants based on their respective risk-bearing capacity. In such market, government would play a minimal role. However, complete markets for risk do not exist and

risk-related failures can make economic transactions and relations dysfunctional. Reliance on the private markets alone, particularly the financial industry, to produce risk-sharing instruments by itself has not been successful in securing the desired outcome for the collective well-being of societies (Askari and Mirakhor, 2014).

This suggests a clear case of market failure justifying government affirmative action to motivate progress and to protect the public interest (Stiglitz, 1993). Where there is a convincing need to intervene, government action can produce the incentives to initiate a process of stimulating the private sector's progress toward adopting risk-sharing instruments. In fact, government itself has substantial incentive to do so. As the ultimate risk managers and agent (*wakil*) of their respective societies, governments have the necessary clout and ability to make credible commitments on behalf of their societies. Government can remove barriers impeding risk sharing by reducing informational problems through its powers of taxation and spending, monitoring and enforcing capabilities, and its role in money supply. Government can promote risk sharing by issuing instruments that enable household and firms to manage their idiosyncratic risks against which they are not insured and mitigate the adverse impacts of shocks to their economic well-being through diversification of their sources of income.

For the Islamic finance industry to achieve its objectives, development of medium to long-term government risk-sharing instruments – as a replacement for usual bonds – to facilitate risk hedging is of paramount importance. As a first step, medium to long-term instruments of risk sharing could be designed to finance the government's development budget. Typically, an emerging market or developing country allocates 30–40 percent of its budget to development expenditure financed by taxes and/or domestic and external borrowing. However, domestic borrowing has adverse effect on income distribution. External borrowing, which represents a leakage out of the economy, aggravates income

distribution, exposes the economy to the risk of "sudden stop." Issuing equity instrument based on a portfolio of domestic development projects can improve domestic income distribution and the resilience of the economy. The remainder of the budget could be financed by a second perpetual risk-sharing instrument whose rate of return would be a function of the GDP growth or linked to the rate of return in the real sector of the country. Government could also use these equity instruments to convert its debt into risk-sharing instruments to broaden its fiscal space.

Macro-market equity instruments also offer opportunities for international risk sharing, allowing other governments and investors to purchase these instruments to hedge and diversify their own risks.[2] Consider the present problem confronting Europe and the global economy. Risk sharing could be an effective alternative to the debt-based instruments adopted by European countries as a solution to their sovereign debt crises. Consider the possibility of a macro-market instrument issued jointly by the International Monetary Fund, the World Bank and the European Central Bank, with additional credibility provided by some G-20 members, where the rates of return to these instruments are linked to the growth of the debtor country's GDP. This could accord relief to the countries at risk of sovereign default, provide the economies of these countries fiscal and growth space, and eliminate the threat to the global financial and economic system.

Conventional monetary policy depends on a transmission mechanism that transmits policy signals to the private sector through the banking system. However, the objective functions of the monetary policy authorities and the banking system are different. As observed in the years following the 2007/2008 global financial crisis, the banking system either weakens or distorts the policy signals as it passes them to the

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[2] Prices of these instruments would vary as new information about national and global developments become available (Shiller, 2003).

private sector. The proposed risk-sharing instruments allow monetary policy signals to be directly transmitted to the private sector for portfolio adjustment since the instruments would be sold in the retail market. This strengthens the potency of monetary policy. Further, banks and financial institutions could utilize these instruments to replace interest-rate-based government bonds, thus delinking their balance sheet from the central bank's overnight rates.

Financing a government's development budget through equity participation securities that are issued in low denomination and traded in the retail market would allow for wide participation of the population in the government's activities. Such involvement of citizens as shareholder-owners of public projects can promote better governance through natural oversight which, in turn, enhances confidence and trust in public institutions. Ownership of public goods by citizens can also reduce the tragedy of the commons to some extent, thereby strengthening social solidarity. Such alternative methods of financing government expenditures would be particularly viable in the Asian countries with high saving ratios. Further, equity-participation securities would promote financial inclusion and provide a hedge against idiosyncratic risks to the public at large. This appeals to the Islamic principles that wealth and property should be circulated in the economy as investment and expenditure. This would also encourage participation and increase trust in financial markets. Having returns on investment that is based on real capital productivity can also reassure both sophisticated investors and households with surplus funds that their investments would be driven by economic and business fundamentals rather than by speculation.[3]

Since 1985, a series of the International Monetary Fund working papers have shown that a risk-sharing economy where the rate of return to finance is derived directly from the rate of return to the real sector

[3] For detailed discussion, see Askari et al. (2011), Mirakhor et al. (2012), Askari and Mirakhor (2014), and Haneef and Mirakhor (2014).

produces a stable equilibrium (Khan and Mirakhor, 1987). In a recent study building the case for GDP-linked *sukuk* for public sector funding and debt management, Diaw et al. (2014) propose for the rates of return to be linked to the growth of country GDP using forward *ijarah* as underlying contract particularly for nonrevenue generating infrastructure project financing. The use of forward *ijarah* allows *sukuk* holders, through their representative, to undertake the construction of project and receive lease payment comprising a profit element over the tenor of the project. Theoretical analysis and empirical evidence from five countries (Algeria, Bahrain, Malaysia, Senegal and Uzbekistan) suggest that the returns on the GDP-linked *sukuk* are higher than the returns on a comparable straight bond, proportionate to the higher risk in the former's case. Portfolio optimization based on the Markowitz mean-variance framework also reveals that the GDP-linked *sukuk* can offer diversification opportunities to investors.

For private sector funding and revenue-generating infrastructure projects, Diaw et al. (2012) propose an incentive-compatible *sukuk musharakah* model that links the share of the issuing entity in the profit to its performance in addition to a convertibility clause. Performance of the firm is measured according to a benchmark using the sector's return on equity, adjusted with the firm beta, on the basis that *sukuk musharakah* holders face similar risk to that of the equity holders. The profit-sharing ratio is variable in a way that the equity holders have equal return as the *sukuk* holders when the firm's return to capital is equal to the benchmark. Where the firm's return to capital is higher than the benchmark, the equity holders will have higher return compared to *sukuk* holders. In contrast, the equity holders' return will be lower than that of the *sukuk* holders when the firm's return to capital is below the benchmark. The proposed model is a new class of financial instruments with regard to the residual nature of the claim and its limited tenor. It can offer diversification opportunities, tradability, and higher return (due to higher risk as neither the profit nor the capital is guaranteed). To

address agency problem arising from such venture, the *sukuk* can be converted into common shares upon occurrence of events that the contracting parties may determine. This option of convertibility helps to prevent the moral hazard arising from projects that have low returns in the early years, although the redemption price in the case of conversion is a subject that requires further study. The authors argue that the proposed model would imply lower probability of bankruptcy since the *sukuk* are equity-based instruments despite that it may entail more financial cost for companies. The model has implications for public-private-partnership opportunities as the private sector is incentivized to deliver the service in a cost-efficient and competent manner given that the return is linked to the availability of revenues from the infrastructure projects.

A recent development in the democratization of financial capital through the widening of financial access is the facilitation of retail participation in the *sukuk* market by the Securities Commission Malaysia. As part of the second Capital Market Master Plan, the Securities Commission Malaysia developed a framework for retail bonds and *sukuk*, known as the Exchange Traded Bonds and *Sukuk* (ETBS) framework, in September 2012, to enable greater retail participation and access to a wider range of investment products. Retail investors can benefit from the range of low-risk investment products and diversification for risk management purpose. The trading of these retail *sukuk* on the exchange (Bursa Malaysia) or over-the-counter (OTC) via appointed banks is expected to further enhance liquidity in the secondary market. This is supported by an investor protection framework comprising a robust disclosure regime (which includes requirements for prospectus, trustee and trust deed), mandatory credit rating by a registered credit rating agency, and investor education initiatives. Pursuant to the ETBS framework, Danainfra Nasional Berhad, a government-owned entity mandated to undertake the development of Malaysia's first mass rapid transit project, issued the first retail (exchange-traded) *sukuk* in February

2013. This RM1.5 billion government-guaranteed issuance provides the opportunity for investors to have a direct stake in the infrastructure development in Kuala Lumpur (Mahmood, 2012, 2013).

In the future, the development of retail equity instruments that is linked to the growth of the country's GDP without government guarantee would be an important step toward greater sharing of risk. Strengthened legislative or parliamentary oversight and robust investor protection would be crucial to enhancing the credibility of these instruments.

Harnessing Social and Financial Capital through Social Impact Partnerships and Enterprise Waqf Fund

For years, a number of preventive social programs to reduce chronic social problems and their associated costs have been invested by philanthropic foundations and implemented by nonprofit service providers. However, foundations, charitable organizations, and nonprofit providers do not have sufficient resources and the capacity to deliver improved social and environmental conditions at the desirable scale. The Social Investment Taskforce estimates that three-quarters of charitable social service providers in the United Kingdom had insufficient capital that can span more than three months (Cohen, 2014). Social-welfare programs provided by the government are often remedial and ineffective rather than proactive in addressing social issues before becoming real problems. Reasons cited for this inefficiency and misallocation include restrictive legislative mandates in the provision of public services, insufficient public funds to scale preventive demonstration projects, and lack of clear constituencies for prevention (Godeke and Resner, 2012). Estimates by McKinsey & Company shows that federal, state, and local governments in the United States spent between US$6 billion and US$7 billion on remedial programs in 2010 for homeless constituents alone. Indeed, preventing social problems can save

significant cost especially for the government and yield societal benefits by reducing crime, building community, and enhancing social well-being (McKinsey & Company, 2012). The need for a social entrepreneurial revolution to confront social challenges has led to the development of innovative social finance and impact solutions in several developed countries in recent years.

Intersecting the public, private, and social sectors, social impact bond (SIB) is a novel multi-stakeholder partnership approach for expanding the scale of preventive social programs. Policy makers and government create partnerships with philanthropic funders, impact investors,[4] nonprofit service providers, and intermediaries to scale evidence-based social solutions using multi-year growth capital. Originally known as "social impact partnerships," the "pay-for-performance" or "pay-for-success" contract seeks to address a defined social or environmental problem. While SIB has bond-like features (a fixed duration and variable rates of return tiered to the performance target of the social program), it is essentially a multi-stakeholder partnership where the return on investment and other fees (success fees and performance bonus) are subject to the performance of the program and outcome risk is shared among the stakeholders. This makes SIB a unique form of financially engineered instrument that is driven by social purpose.[5]

First introduced and piloted in the United Kingdom in September 2010, SIB has generated interest globally in the social and ethical investing communities.[6] The United Kingdom Ministry of Justice in collaboration

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4 Impact investment is "where achieving a social goal is embedded within the business model and where social outcomes are continuously measured alongside financial results" (Cohen, 2014, p. 6).

5 The term "SIB" will be used in this chapter due to its common usage in the literature.

6 Lessons from other programs can help inform SIB uptake. For example, the World Bank pioneered the first social development bonds to raise funds for emerging economies as far back as 1947. Energy-service companies have been used by the public sector to address energy-management problems on a shared-savings model in the United States since the 1970s. See also Human Capital Performance Bond.

with Social Finance UK issued £ 5 million of SIBs to social impact investors to fund a pilot rehabilitation program for 3,000 young offenders in the town of Peterborough expected to be released within six years. While the Peterborough SIB was closed early to be compatible with the United Kingdom Transforming Rehabilitation program (which will be operated as traditional public service contracts without social investors), the initial progress of the SIB funded program has been encouraging. Four years since its first launch, the program has reduced reoffending by 8.4 percent in the first cohort of 1,000 prisoners in the treatment group.[7] In May 2014, the United Kingdom Department for Work and Pensions applied the SIB model though a £30 million Innovation Fund to improve the job prospects of the disadvantaged youth and to bring young homeless people into sustainable employment. To date, there are 15 SIB programs in place across the United Kingdom.

SIB has also attracted interests in other parts of the world. In 2012, Goldman Sachs in partnership with the City of New York, Bloomberg Philanthropies, and MDRC, a social services provider, initiated the first SIB in the United States. The US$10 million investment seeks to fund the Adolescent Behavioral Learning Experience program aimed at reducing juvenile recidivism at the Rikers Island correctional facility in New York.[8] Since then, several cities in the United States such as Massachusetts and Salt Lake City have issued SIB with a trend toward enhancing sophistication as models evolve and investors having more risk appetite and awareness. Legislative initiatives have been proposed in the United States for a *Social Impact Bond Act* to enable the Treasury Department to allocate US$300 million for the reimbursement of successful social betterment programs. The SIB Act will create a Federal Interagency

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7 See David Ainsworth, "Peterborough social impact bond reduces reoffending but makes no payout yet to investors," August 7, 2014. Available at http://www.civilsociety.co.uk/finance/news/content/17960/peterborough_social_impact_bond_reduces_reoffending_but_makes_no_payout_yet_to_investors.

8 Instead of having equity features, the SIB was structured as a loan to MDRC and partially guaranteed by Bloomberg Philanthropies over a four-year period.

Council on SIBs from ten government agencies or departments to collaborate with Treasury, and chaired by a member of the Office of White House Policy. Several SIB programs have also been announced in Canada, Belgium, the Netherlands, Germany, Italy, Australia, and is expected to take off in developing economies such as Latin America and Malaysia.

Benefits of SIB

Rooted in social finance and social impact assessment, SIB fosters social innovation for scaling preventive solutions to address challenges confronted by the social sector. In fact, the 2012 McKinsey & Company report *From Potential to Action: Bringing Social Impact Bonds to the US* concludes that SIB are important tools that can potentially help to "solve America's societal problems at scale." Although SIB is relatively new and information about its success is limited, SIB is expected to offer four major benefits under appropriate conditions. First, SIB can help scale up social preventive programs and bring social interventions to more people, although SIB may not be universally conducive for all program areas. SIB can "facilitate the critical handoff from philanthropy – which provides the 'risk capital' of social innovation by funding and testing new programs – to government, which has both the capital and policy influence to take programs to scale" (McKinsey & Company, 2012, p. 12). SIB provides both the scale and a more comprehensive coverage of services. The recipients of the social services benefit from reintegrating into employment and society as well as better health and security. Regular scrutiny and support from intermediaries, evaluation advisers, independent assessors, government, and impact investors helps to increase the capacity and expertise to ensure effective implementation and governance of social programs.

Second, SIB enhances multi-stakeholder collaboration by aligning incentives among stakeholders and focusing on result-oriented objectives. Such

alignment and focus can promote efficiency and cross-sector connectedness among the government, philanthropy, investor, and social sector actors. As a better fit for human nature through incentive structure, the SIB ecosystem leverages on the joint capacity of several actors to address complex problems that cannot be dealt with through traditional silo system. SIB can harness the development of social capital. By improving citizens' lives and strengthening the values that bind the society, government is effectively enhancing the social capital of the society (Cohen, 2014). It instills discipline and honesty. SIB is a long-term collaboration that requires coordinated effort and social trust. David Hutchison, chief executive of Social Finance UK, describes the progress of the Peterborough SIB as taking "a long time to gain the trust of the offenders and to build relationships with police and other stakeholders." SIB also appeals to the spirit of risk sharing, whereby different financial, reputational, operational, and social risks are shared among multiple stakeholders to the extent that each stakeholder is committed to a stake in achieving financial returns and in stimulating social change. In fact, Godeke and Resner (2012), in their report on *Building a Healthy and Sustainable Social Impact Bond Market: The Investor Landscape*, suggest that "creative risk sharing – not risk transfer – will be necessary to address investor concerns about performance risk, illiquidity and deal flow" (pp. 3–4). Over the long term, resolving social issues of the present day, rather than passing them down to the next generations, sets the foundation for a healthy social capital and sharing of risk.

Third, SIB can offer an additional avenue of mobilizing sustainable funding for social projects and enhance the effectiveness of current funding. The use of private capital reduces fiscal pressure especially in countries where taxation is low and government funds are limited. The focus on paying for results rather than paying for activities allows the government to reallocate resources efficiently to where it is most needed and helps to reduce the need for international borrowing and overseas aid. By anticipating and addressing social issues before they arise, SIB facilitate the shifting of resources from remediation to less costly

preventive solutions. It essentially monetizes social outcomes by reflecting better value in terms of prevention vis-à-vis remediation. At a time where philanthropic funding is under pressure, the focus on performance and social outcomes above the act of charitable giving also helps to unlock more capital within and beyond philanthropy. Indirectly, the successful implementation of SIB can potentially lower the comparative costs for taxpayers. For example, a reduced rate of recidivism would lead to a reduced need to fund prisons, thereby benefiting the government in terms of savings and the society in terms of lesser crime. While SIB funded programs are relatively more costly, they offer better value in the long term if proven to be more effective than non-SIB funded programs.[9] In fact, SIB has now become a potential funding source for other types of projects such as public health and energy efficiency (Bennett and Jain, 2014).

Fourth, SIB can become an alternative investment asset class that has low correlation to the conventional financial markets. SIB is subject to less market volatility as its performance is driven by the outcome of the social program (e.g., the reduction in the re-incarceration rate and savings to the government) rather than macroeconomic shocks, business cycles, or market behavior. This offers potential portfolio diversification benefits over the medium to long term. Given its contribution to social well-being, SIB can attract a diverse set of forward-thinking investors such as high-net-worth individuals, private foundations, philanthropic foundations, family offices, community development financial institutions, Community Reinvestment Act banks, pension funds, insurance companies, sovereign wealth funds, and development banks who can provide multiple funding streams to social programs (Godeke and Resner, 2012). Some charitable foundations view that it is natural to achieve social objectives by directly investing from their balance sheet rather than

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[9] SIBs have been assessed to be well suited to multifaceted behavior change interventions that assist individuals to change their behavior for positive social benefits, ranging from drunk driving campaigns to low-income first-time mothers programs (for example, the Nurse-Family Partnerships) (McKinsey & Company, 2012).

through an outright grant (Cohen, 2014). In this regard, philanthropic foundations can provide capital for the early transactions and community development financial institutions can be a bridge between philanthropy and mainstream investors (Godeke and Resner, 2012). Financial institutions such as Goldman Sachs and Bank of America Merrill Lynch have also started to support SIBs in the United States.[10]

The SIB Ecosystem

There are seven stakeholders groups involved in SIB: constituents, government, nonprofit service providers, investors, intermediaries, evaluation advisers, and independent assessors (McKinsey & Company, 2012). At the heart of the SIB ecosystem are the constituents who directly benefit from the social services funded and scaled through a SIB. These constituents include the homeless, incarcerated individuals, youth at risk of unemployment, problem families, early childhood education, and asthma in the disadvantaged population who may or may not be receiving remedial services by state and local governments that are funded through taxpayer contribution. In the SIB structure, these constituents are known as constituent treatment group whereby the program results for this group are compared with constituents who do not receive preventive programs. To improve the well-being of the constituents by scaling preventive services, the government (federal, state or local) jointly develops a SIB with an intermediary.[11] Linking all relevant stakeholders, the intermediary identifies evidence-based program solutions, raises fund to bring program to scale, project manages

[10] Through the Guidelines on Mixed Motive Investing, the Charity Commission of the United Kingdom is enabling trustees to consider how investment from endowment can achieve social goals. A £250 million Impact Investment Pool has been created by five Local Authority Pensions Funds in the United Kingdom.

[11] At the federal level, the government can facilitate cross-agency cooperation and provide supplementary financial support for the assessment of the program.

the program, and works closely with nonprofit service providers to ensure successful implementation of the program.[12]

Investors of SIB can range from high-net-worth individuals, community development financial institutions to private foundations and major philanthropists who provide capital for the services of the nonprofit service provider, the intermediary, the evaluation adviser, and the independent assessor. These impact investors generally prioritize social impact over financial returns. Investors are repaid capital plus a return on investment by the government via the intermediary if the program is successful in meeting the predefined performance metrics.[13] In the event the social program does not meet its target, investors bear the loss of capital, corresponding to the cost-saving benefits not received by the government and the society. In such event, investors will be, in effect, making a charitable contribution (Cohen, 2014). Views are divided when it comes to the financial returns or the pricing of the SIB (whether it should be based on social outcomes or a portion of government savings investors helped the government generate or a combination of both). Financial implications for investors should ideally be linked to the realization of social outcomes rather than government savings alone. This is because while savings may exist in the system, they may take a longer period to be fully realized beyond the lifespan of the SIB. For example, the pro forma analysis of a single hypothetical SIB by McKinsey & Company (2012) reveals that it takes 12 years to break even,

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[12] Social Finance, Third Sector Capital Partners, the Harvard Social Impact Bond Technical Assistance Lab, Private Capital for Public Good, and Finance for Good are among SIB intermediaries. According to the McKinsey & Company (2012)'s report, community development financial institutions, community development venture capital funds, and community foundations are the potential SIB intermediaries for SIB to reach critical mass. Community development financial institutions typically have systems to measure their social impact and have the potential to enhance their ability to underwrite SIB issuances (Godeke and Resner, 2012).

[13] In the Peterborough SIB, investors could receive up to £8 million (a return of 7.5 percent) after six years if the reoffending rate is reduced by 7.5 percent, or up to return of 13.5 percent if the reoffending rates are even lower.

with only 58 percent of the taxpayer benefits realized within the 12 years of intervention. Another difficulty with realization of savings is that savings may also be redeployed to the underserved in new populations or segregated across different agencies and locations. Although measuring social impact has its own challenges, outcomes are considered the most accurate measures of the performance of a social program.[14] In the near term, evidence of decreased use of remedial services as a result of successful preventive programs under SIBs can be a good indicator of social outcome (McKinsey & Company 2012).

With the up-front capital from investors, the intermediary channels multi-year funding to selected nonprofit service providers who are assigned to deliver evidence-based preventive programs to constituent treatment group. These nonprofit service providers are usually seeking multi-year growth capital to expand their programs and have proven operating model, capacity to scale, as well as local community knowledge.[15] During the multi-year SIB contract, the intermediary monitors the performance of the program through an evaluation adviser. The evaluation adviser determines the evaluation approach, defines the performance outcomes, monitors ongoing progress, and recommends course corrections if required based on interim results. To determine whether the performance targets have been met, an independent assessor reviews and reports the performance of the constituent treatment group relative to a counterfactual. This report is crucial for the government to assess whether, and how much, to pay investors. In terms of fees, the intermediary receives a management fee while the evaluation adviser and independent assessor are paid on a fee-for-service basis out of the SIB fund. If the SIB program is successful, the intermediary is given a success fee and the service providers receive a performance bonus.

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[14] Governments' pay-for-performance contracts to provide public services have been contingent upon outputs, not outcomes (Godeke and Resner, 2012).

[15] In the case of the Peterborough SIB, the service provider was a special purpose vehicle established by the intermediary.

Above all, the role of the government is crucial in making the social program a success. Sir Ronald Cohen, the Chair of the G8 Social Impact Investment Taskforce, suggests that government has three important roles. First, government can create an ecosystem that supports social entrepreneurship and impact investment. The United Kingdom, for example, has been at the forefront in building such ecosystem. Starting with the formation of the Social Investment Taskforce in 2000 and the Unclaimed Assets legislation of 2008, the government has been instrumental in the establishment of Big Society Capital and announced tax incentives to further support impact investment via SIB. The United States administration has provided outcomes funding for SIBs and France has mandated pension contributions to go to funds, which invest 7 to 10 percent of their assets in addressing social and environmental issues. Second, government can be a constructive commissioner of impact investment by focusing on the cost per successful outcome rather than the cost of impact investment. Third, government can contribute to international development and aid (Cohen, 2014). There is thus an important need to have government and policy makers that are willing to create cross-sector partnerships and political champion who is sincere in supporting the initiative.[16]

Initiatives to Facilitate the Development of SIB Ecosystem

Developing innovative solutions and a new ecosystem are not without challenges and risks. This is especially true when the solutions have to be proven, more beneficial, scalable, and replicable. These challenges range from understanding the role of investors and intermediaries by the

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[16] McKinsey & Company (2012) listed seven basic eligibility requirements for SIB: prevention-focused, multiyear track record, record of rigorous evaluations, deliver statistically significant results, meet the needs of sizable population, replicable and scalable, and deliver taxpayer benefits in less than five years.

commissioners and service providers, agreeing to contract terms to satisfy all parties, high financial risk to issues of scale and generating evidence that demonstrates the effectiveness of interventions to investors and commissioners (Ecorys UK and ATQ Consultants, 2015). A number of risks that could impede the adoption of SIB have been identified. These risks are coordination risk, funding risk, implementation and impact risk, measurement and pricing risk, and government counterparty and reputational risk, which collectively have an impact on financial and social risks to the stakeholders of SIB. It is therefore crucial for the risks to be shared on equitable terms rather than pure risk shifting and transfer at the expense of one or the other. Several initiatives have been proposed to address these risks and to facilitate the development of the SIB ecosystem (Table 1).[17]

Table 1

Risks	Initiatives to address risks
Coordination risk	• Set up Social Impact Taskforce and working groups to catalyze and strategize the development of the social impact investment market (e.g., the Social Impact Investment Taskforce established by the G-8) • The federal government is generally in a better position to facilitate cross-agency collaboration. A dedicated team (possibly with central decision-making authority) can be set up to expedite coordination across programs and agencies (e.g., the Centre for Social Impact Bonds within the Cabinet Office in the United Kingdom and Federal Interagency Council on SIBs proposed in the United States)
Funding risk	• Diversify investor base beyond purely philanthropic funding over time • Launch SIB fund and SIB fund of funds to widen the market and to provide liquidity to investors (e.g., the United Kingdom Cabinet Office's £20 million Social Outcomes Fund)

[17] References are drawn from McKinsey & Company (2012), Godeke and Resner (2012), and Cohen (2012), among others.

Table 1 (continued)

	• Government to incentivize the establishment of a social investment bank to eventually underwrite issuance of SIB without credit enhancement (e.g., the market-building role of Big Society Capital in the United Kingdom).[a] A new group of foundations could also participate in underwriting the issuance over time • Regulators to facilitate the participation of community development financial institutions and Community Reinvestment Act banks as potential investors in SIB • Structure phased and incremental capital drawdowns subject to meeting specific or interim performance targets in order to enhance structural liquidity at the transaction level (e.g., the New York City's SIB for incarcerated youth transaction) • Offer tax incentives to reduce cost of capital for certain social impact bond issue (e.g., the New Markets Tax Credit in the United States and the Social Investment Tax relief in the United Kingdom) • Standardize SIB through common templates and consistent designs to enhance investors' confidence and evaluation of investment opportunities (e.g., the UK Cabinet Office's template contract and guidance notes on SIB) • Form a club of impact investors to promote culture of investing equity in social organization • Charitable organizations can enhance the public's trust by signaling their trustworthiness to the public. This can be done through a system of accreditation as donors who are aware of the accreditation system have more trust in charities and provide more fund to charity, which can be subsequently used to invest in SIB
Implementation and impact risk	• Pilots can be conducted in multiple program areas under various conditions and environments • Develop and share best practice methods, models, and experience to facilitate cost-benefit analysis and learning process • Develop capabilities checklist, interview guide, document request list, data-gathering template, scoring rubric, and streamlined due-diligence process guideline to enable thorough capabilities due diligence. Term sheets and report formats can be made publicly available (e.g., tools developed by McKinsey & Company available at payforsuccess.org)

Note:

[a] The Big Society Capital is funded with US$1 billion in equity from dormant bank accounts and contribution from several banks.

Table 1 (continued)

Risks	Initiatives to address risks
	• Promote SIBs that scale proven rather than promising interventions at the early stage of SIB development • Develop capable service providers and social impact investment intermediaries to deliver and project manage social programs, with focus on outcomes, regular staff training, quality control, and monitoring • Encourage philanthropic foundations to provide initial funding to build the capacity of SIB intermediary, to support research and feasibility study, to fund information sharing platforms and to support evaluation design (e.g., support by the Omidyar Network and the Rockefeller Foundation) • Collaborate closely with professional evaluation adviser who possesses program area expertise and evaluation experience to make midcourse corrections based on ongoing assessment • Engage independent assessor who has specific content knowledge and experience with objective assessment. Once the SIB ecosystem is more developed, a national evaluation and assessment committee comprising representatives from within and beyond the SIB stakeholders can be established to enhance independence, governance and oversight • Enhance capacity of evaluation and assessment by consulting and enlisting external experts and risk evaluators who specialize in both for-profit and nonprofit evaluation • Provide technical assistance to state and local governments to develop pay-for-success contracts using SIB (e.g., initiatives by the Rockefeller Foundation and the Social Impact Bond Technical Assistance Lab at the Harvard Kennedy School)
Measurement and pricing risk	• A system that accounts for the cost for each social issues and the cost for intervention to resolve social issues should be made available[(b)] • A robust and coordinated electronic data sharing platform can be formed to link investors and investees, donors and recipients, assess the success of new program, track cost, and service utilization at the level of constituent and various government agencies • Market pricing will evolve when there is an organization that can serve as pricing benchmark (e.g., a social investment bank can become the price setter when it decides to underwrite a particular SIB)

Note:

[b] The Washington State Institute for Public Policy considers three groups (constituents, taxpayers, and avoiders/nonparticipants in other nontaxpayer roles) in assessing the costs and benefits of government-funded social programs.

Table 1 (continued)

	• Adopt robust methods that can allow for comparison of the constituent group with the control group • Develop defined, audited performance metrics that can be presented in a standard and transparent way
Government counterparty and reputational risk	• Government (at federal, state or local levels) may not have the legal authority to participate in the SIB (as issuer of SIB or as obligor to pay investors). To address both legal and reputational risks, special legislative authority, regulatory exemptions, or executive actions can be crafted for government to participate in SIB (e.g., the Massachusetts legislature created a US$50 million Social Innovation Financing Trust Fund in July 2012 for the state to fulfill its potential obligations in SIB transactions). An escrow account can also be established to ensure that the government fulfills its obligations • To address public concerns against SIB as a "privatization" of government savings to wealthy investors, public education and stakeholder awareness campaign of the objectives and functions of SIB can be conducted through strategic communication and information sharing channels (e.g., the Pay for Success Learning Hub launched by Nonprofit Finance Fund and the G8 Social Impact Investment Forum in 2013) • Work with investors to craft risk-sharing strategies through transparency and coordination with all the stakeholders

Islamic Finance and SIB

SIB has recently emerged as a potential new frontier for the Islamic finance industry. At a time where there is mounting emphasis for finance to serve the society, the principles of Islamic finance fits well into this new dynamics given its emphasis in promoting (business and social) entrepreneurship and in creating shared values within the society. In recent years, there have been calls for more focus on the social impact of Islamic finance investments. Sheng (2013), for example, highlights the "need for Islamic finance to move toward more professional benchmarking and measurable impact on social issues and development" (p. 4). In a recent article exploring the potential of social impact *sukuk*, Michael Bennett and Akinchan Jain (2014) of the World Bank suggest that a social impact *sukuk* appeals to investors from both the Islamic and

conventional ethical finance sectors as it combines "true risk sharing and a focus on a specific social cause with a fully *Shari'ah* compliant *sukuk* structure" (p. 27). There is complementarity of the SIB concept and Islamic finance for at least two reasons. First, the risks of the social preventive program not achieving its target and the loss of capital invested are shared among the investors and the users of invested funds. At a broader level, the government suffers reputational risk and loss of trust for not discharging its duties in improving social welfare and order, while the society risks losing the potential benefit from better social outcomes. Second, SIB is intended to finance worthwhile social causes with measurable impact. These reasons appeal to the risk sharing and social justice principles of Islamic finance.

In this regard, Bennett and Jain (2014) propose that social impact *sukuk* could be utilized to fund programs with a worthwhile public purpose such as financing the purchase of mosquito resistant bed nets in malaria-stricken regions across Africa, Asia, and Latin America. The proceeds from the *sukuk* issuance can be employed to purchase and lease bed nets to the government. The timing and amount of lease payments from the government can be set based on the success in the distribution of nets or the decrease in the number of malaria cases, measured through an independent assessor. In fact, the lease payments can vary according to the progress or target achieved, which reflect the savings being "realized" by the government. Indeed, a dollar invested in preventing malaria can produce significant savings in the form of lower health expenditures and higher productivity from a healthier workforce for many countries. This also promotes intergenerational risk sharing by ensuring that the next generation will not inherit the health burden (and cost) from the present generation.

Several *Shari'ah* compliant structures for SIB have been proposed. For example, an Islamic SIB can be arranged on a *Jualah* structure (fee based contract for specific service rendered), which is a contract of service based on the successful completion of difficult task. This structure can

be a public offer where the reward is provided to whoever delivers the work first. Mujtaba Khalid of the Islamic Finance Council UK propose that a government may put an open tender for a social project under a Jualah SIB and a firm can take on the project and seek tax rebate as a form of return.[18] Other potential structures include (i) *wakalah bi istithmar* (agency to invest) model in which the intermediary acts as the investors' agent; (ii) *musharakah* (profit and loss-sharing partnership model) where the intermediary partners with the government for the management of the program; and (iii) *mudarabah* model where the investors provides capital to the intermediary and nonprofit service provider (both acting as *mudarib* of the capital provider). Key to the *Shari'ah* compliance of social impact *sukuk* is the upfront arrangements on the profit (i.e., from where it is generated and for what purpose it is been paid) and the return of principal (i.e., the extent to which it is subject to the performance outcome (and associated risks) of the transaction rather than being guaranteed or completely protected).

Recently, initiatives have been taken to facilitate the rise of these innovative and worthy social capital investments. The framework for Socially Responsible Investment *Sukuk* developed by in the Securities Commission Malaysia in 2014 was a positive response to the rising trend of SIB and green bonds issued globally to finance sustainable activities. The US$500 million "Vaccine *Sukuk*" launched in December 2014 for the International Finance Facility for Immunisation was the first international socially responsible *sukuk* that provided funding to support immunization of children against preventable diseases in the poorest countries. In May 2015, Khazanah National Bhd, the sovereign wealth fund of Malaysia, launched the first Ringgit-denominated sustainable and socially responsible investment *sukuk* to improve accessibility to quality education in Malaysia's government schools through its Trust Schools Programme. The social impact of the "Pay for Success" *wakalah*

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[18] This was reported in the Islamic Finance *news* on May 14, 2014.

bi al-istithmar structure is measured based on pre-determined Key Performance Indicators (KPIs) over a 5-year timeframe. If KPIs are achieved, investors will forego a pre-agreed percentage of the nominal amount due under the *sukuk* as part of their social obligation. If KPIs are not met, investors will be entitled to the nominal amount due under the *sukuk* in full. These inaugural issuances are set to be launch pad for more innovative methods of Islamic social financing in the future.

Waqf and SIB

The proven track record in the development of public facilities and services in many Muslim cities 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.[19] In recent years, there has been growing interest in the subject of *waqf* across the globe especially in the Muslim world and concerted effort to revive the institution of *waqf* in order to unleash its potential value (Kamali, 2014).[20] Efforts at revitalizing the institution of *waqf* include the *Awqaf* Properties Investment Fund of the Islamic Development Bank, the proposed Corporate *Waqf* Master Plan announced in the 2013 Budget of Malaysia and the proposed National *Waqf* Framework for Malaysia (Azmi, 2014).[21] In a special address at the fifth Securities

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19 Notable examples funded or built under the *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 of Al-Azhar in Egypt, University of Cordova in Spain, Universitas Islam in Indonesia, Shishli Children Hospital in Istanbul and Al Noori Hospital in Damascus. Among the facilities funded by *waqf*, education has been the largest user of *waqf* revenues throughout the Muslim world (Makdisi, 1981; Kamali, 2014).

20 The global size of waqf assets is estimated between US$105 billion to US$1 trillion (Singh, 2014). For a recent study on the subject, see the Islamic Social Finance Report 2014 by the Islamic Research and Training Institute of the Islamic Development Bank Group and Thomson Reuters.

21 The proposed National *Waqf* Framework aims to create a legal framework to facilitate the proper management of *waqf*, to define the jurisdiction and roles of different stakeholders, as well as to agree on the scope of beneficiaries in Malaysia.

Commission Malaysia-Oxford Centre for Islamic Studies Roundtable on Islamic Finance in 2014, His Royal Highness Sultan Nazrin Shah, Financial Ambassador of the Malaysia International Islamic Financial Centre, remarked that the galvanization of *waqf* assets to support a wide spectrum of activities can contribute toward stronger GDP growth in terms of economic value for the nation and employment opportunities for the population. The institution of both religious and philanthropic *waqf* can also provide public services that relieve some burden on public finances, allowing government to allocate resources efficiently toward more broad-based nation-building. The application of *waqf* assets in social impact and socially responsible initiatives can lead to a more inclusive society and sustainable environment. In the context of Islamic finance, the emphasis on *waqf* is in accordance with the drive and initiatives to identify new growth segments that can expand and strengthen the development of the Islamic finance industry (HRH Raja Nazrin Shah, 2014). Here, too, the potential of mobilizing large amount of financial resources through instrumentalization of the *waqf* institution by a globally credible Islamic financial institution is significant (Mirakhor, 2004).[22]

Against this backdrop and calls for *waqf* institutions to take a more significant step in expanding their activities to secure impactful outcomes, cash *waqf* can be utilized to further support the funding of social program and some of the challenges confronting SIB. A cash *waqf* is a

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[22] According to Wahid (2014), Islamic banks can provide cash *waqf* platform to customers, financing to *waqf* institution or developer to develop *waqf* property, micro-financing to the needy, and act as trustee or manager to manage or invest in *waqf* properties. For example, Maybank Islamic Berhad, the largest Islamic bank in Malaysia, announced the establishment of a RM20 million *Waqf* fund at the tenth World Islamic Economic Forum (October 2014, Dubai). The fund is set up in collaboration with Islamic Religious Council of the Federal Territory in Malaysia for a high-impact initiative that is set to be the prime catalyst in developing and broadening the horizon of *waqf*. Investment will be made in portfolios including *sukuk*, equities, balanced fund, and real estate. Other examples include Wakaf Selangor Muamalat by Bank Muamalat Malaysia Berhad and Perbadanan Wakaf Selangor (a local state council).

cash endowment by a founder with the purpose that the corpus or principal is managed by a trustee or manager in order to earn an income that could be utilized for righteous purposes as stipulated by the founder.[23] According to Alias (2012), the usage of cash *waqf* dates back to 1423 CE at Edirne in the Ottoman Empire. Imam Zufar viewed cash *waqf* as lawful based upon public custom because they provided the only readily available funding to the society which was in the interest of the public. This view was adopted by Abū al-Sa'ūd, the supreme religious authority of the Ottoman Empire, in the fifteenth century and the use of cash *waqf* gained legitimacy in the Ottoman land by the end of the seventeenth century. Through money-lending and *istighlal* (collateral for borrowed cash from cash *waqf*) to households and merchants, the income of cash *waqf* was used to provide public services and alms-giving (Çizakça, 2004). Presently estimated at a global size of US$35 billion, cash *waqf* offers viable opportunity for *Shari'ah* compliant asset managers in the Islamic finance industry to manage funds and generate better returns (Singh, 2014).

The sustainability of the *waqf* as well as the realization of benefits to beneficiaries have been emphasized by the OIC Fiqh Academy in its Resolution No.140 (International Council of Fiqh Academy, 2004). The Fiqh Academy supported the diversification and risk management of *waqf* assets investment in the form of guarantee protection and other securities. While *waqf* funds are to avoid high-risk investments so as to protect the *waqf* corpus, cash *waqf* may be invested in contracts such as *mudarabah*, *murabahah*, and *istisna'*. Despite this allowance, modern cash *waqf* is invested in low-return savings or converted by way of *istibdal* (substitution) into low-income generating assets due to lack of strategic investments and spending goals. This "underinvestment" affects the financial sustainability of the *waqf* and results in dependence on costly state assistance (Alias, 2012, 2014; Azmi, 2014).

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[23] Righteous purposes encompass religious, charitable, public purposes, or maintenance of one's family (Mohsin, 2009).

Such underutilization has called for the application for certain venture capital strategies in the investment and spending decisions of cash *waqf* to achieve philanthropic ends. To this effect, a EWF model has been proposed by Tunku Alina Alias in her thesis entitled *Unleashing the Potential of the Waqf as an Economic Institution in Malaysia: Policy, Legal and Economic Reforms*. Drawing insights from American foundations' involvement in venture philanthropy, the EWF model is developed to have a social purpose of venture philanthropy and the business process of venture capital that is applied in accordance to the *Shari'ah. Waqf* is invested to earn sufficient income to ensure its own future sustainability, to meet its own operating costs, and to spend toward its stated purposes. In this regard, Alias (2012, 2014) suggests that *waqf* can be invested in venture capital opportunities and the income can be spent by adopting venture capital techniques in the choice, funding, and management of nonprofit organizations. The following are the operational and policy frameworks of the EWF proposed by Alias (2012, 2014):[24]

1. Endowments are given by selected high-net-worth individuals, companies, or the government by way of collaboration with the *waqf* founders. The original founders of the EWF should be from the local community so that they can better engage with the beneficiaries of local nonprofit organizations. The philanthropic interests have to be aligned with the beneficiaries' causes.

2. The promoters of the EWF are individuals who are experts or well versed with social entrepreneurship.

3. The stated purpose of the EWF is to assist nonprofit organizations to achieve large-scale social or public benefit in a sustainable

[24] On April 10–12, 2008, the National Fatwa Committee of Malaysia resolved that cash endowments are permissible. However, the implementation of the resolution requires issuance of *fatwa* (legal opinion) by each State Islamic Religious Council (SIRC) regarding the permissible areas in which cash *waqf* can be spent or invested. Cash *waqf* and *waqf* share schemes are managed by seven SIRCs (Alias, 2012).

manner. In so doing, the EWF provides *hibah* (gift) or *qardh hassan* (benevolent loan) from the *waqf* income to selected non-profit organizations, depending on the beneficiary.

4. The EWF should be incorporated with its own board of directors (as trustees). If the EWF is not permitted to be incorporated under the law, the trustee shall be an incorporated body in the form of a statutory body or an incorporated trustee. The EWF shall apply for tax-exempt status.

5. The EWF has a three-phase life cycle. In the first phase (between five to ten years), the EWF focuses on building its assets by raising funds and earning income. Endowments to the EWF should of sufficient scale to meet the operating and investment needs of the EWF, as well as to generate sufficient income over the short to the medium-term. The EWF must diversify its sources to include earned fees from services rendered, sales of goods, participation in social business, and management of investment portfolio or donor-advised funds, as well as organize fundraising activities.

6. In the second phase, as the *waqf* fund reaches a critical mass, the fund is managed and invested. An investment policy for the EWF should be developed to outline the parameters and strategies for investing in different Shari'ah compliant asset classes. In particular, the investment policy should take into account short-, medium, and long-term requirements and risks including factors that may jeopardize the *waqf* such as inflation, taxation, or administrative expenses. The EWF is to have a total-returns approach to investing so that it can diversify its portfolio and possibly include venture capital as an alternative asset class, if deemed appropriate.[25]

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[25] Çizakça (1992) proposed that the *waqf* corpus may be invested in venture capital. However, Çizakça (2011) recognizes the difficulty arising from the riskiness of such investments.

7. In the third phase, the income from the investments and earnings are spent in line with the intended purposes for which the EWF was established by applying venture philanthropy concepts. The manager selects nonprofit organizations with a proven track record of delivering social results and a growth capacity to achieve social impact and sustainability. Disbursement to portfolio nonprofit organizations is made in tranches over a horizon of three to five years. A portfolio of beneficiaries is useful for the estimation of the funding required. Exit from the nonprofit organizations occurs when the target of sustainability is achieved. Returns to the EWF are measured in terms of social impact rather than in financial terms.

8. In all the three phases, the *waqf* will be administered by the promoters as managers of the EWF, in consideration for which a fee may be paid. The managers will manage and invest the corpus of the cash *waqf*, support, and monitor the performance of nonprofit organizations, provides advice, and business support to the nonprofit organizations, provide regular reporting to donors, and manage the rate of endowment.

9. The *waqf* manager is to devise a set of metrics to measure the results of the EWF and each of the nonprofit organizations. These metrics can include: financial goal in terms of increase in the value of beneficiary's lifetime income stream, financial efficiency such as low administrative expense to income ratio, satisfaction level of donor investors, sustainability of non-profit organizations, level of public awareness, accumulation of intellectual capital, success of social programs in terms of the number of public served or the degree of public benefit delivered.

10. A *waqf* governance framework encompassing a Code of Governance and a Code of Ethics are necessary. Financial reporting, public access to financial accounts, reporting of the activities, external

audit, and website are crucial to enhance transparency and public confidence.[26] An oversight body that has powers in rule making, enforcement, mobilization, agenda-setting, or information gathering can be given the authority to take legal action against individuals for breach of legal duties.[27]

The EWF model can support the SIB in three ways: investing, spending of cash *waqf* return, and by becoming a SIB intermediary. First, let us delve into investing. As far as the investors are concerned, the SIB has a dual purpose: it has to achieve maximum social impact and give satisfactory financial returns with a repayment of capital. In the case of *waqf*, which is an outright endowment, the *waqf* endowers are donors who do not expect a return of endowment or any returns (except in limited cases, for example, the fixed term or temporary *waqf*s in the form of usufruct—permitted only by the Maliki school of thought and allowed by the state of Johor in her *waqf* regulations) (Kamali, 2014). While the *waqf* endowers may not be direct investors in SIB who expect returns, it is possible for the *waqf* manager to invest in SIB through the EWF, provided that only the income from the initial *waqf* fund should be used for such investment in accordance with the investment policy. In other words, *waqf* manager can be impact investors.

One of the primary considerations of investing *waqf* fund in SIB to generate income and capital growth (which will later be applied to the stated purposes of the *waqf* and reinvested if deemed appropriate) is the question of risk and return. In the United States, for example, the requirement to distribute a minimum of 5 percent of the average fair value of the foundation's assets annually toward program spending

[26] Alias (2012, 2014) also recommends the development of *fiqh* on fiduciary responsibilities in the area of expected duties of care, loyalty and obedience, and conflict of interest.

[27] In terms of policy reforms, Alias (2012, 2014) recommends that tax incentives can be given to prospective donor investors and an introduction of an incorporated form of *waqf*, among others.

(section 4942 of the *US Tax Code*) makes it necessary for tax-approved or tax-exempted foundations to generate sufficient return from their investments. According to Alias (2012, 2014), foundation managers in the United States usually ensure a 9 percent annual return as a hurdle rate or benchmark to meet payout requirements and administrative expenses. For the EWF to perform at this level, the EWF can adopt a total-return approach to investment. This approach focuses on the level of the investment return and offers foundation the flexibility to explore a wider range of investments irrespective of whether the returns come from income, rent, profit, dividends or capital gains. Hence, foundations can invest in assets that have good growth prospects even if the assets pay little or no income, so long as the overall return is sufficient to meet the needs of current beneficiaries. The total-return approach has been enabled through legislation in a few countries. For example, in the United States, the Uniform Management of Institutional Funds Act 1972 enables endowments to invest based on the "prudent man" rule and implement investment policies pursuant to the "total return investing" concept (Kochard and Rittereiser, 2008). In the United Kingdom, since January 1, 2014, trustees of charities with permanent endowment are able to adopt a total-return approach to investment without having to obtain an Order from the Charity Commission (Charities [Total Return] Regulations 2013 and Charities Act 2011). In the case of SIB, while there is no established track record of the returns in SIB investment, targeted financial returns typically range from 7.5 to 13.5 percent as in the case of the Peterborough SIB. As such, SIB can be considered an alternative capital growth asset class for the EWF from a risk-return perspective.

Second, *waqf* institution can participate in the provision of capital to entities that are unable to access the mainstream financial markets. As part of its spending, the EWF can channel *waqf* returns to nonprofit service providers or the intermediary in the SIB ecosystem by way of *hibah* (gift) or, if appropriate, *qardh hassan* (benevolent loan). In this regard, the *waqf* deed needs to state how the return should be applied

to incorporate the particular scope of the SIB.[28] Alternatively, donors can give the *waqf* manager or trustee the discretion to spend from the investment return. The third possible mode of supporting the SIB is for the EWF to play the role of the intermediary in SIB or to become a cointermediary with an existing SIB intermediary by contributing additional expertise and experience to the success of the SIB.

Conclusion

The present financial regime uncertainty has created a valuable opportunity for risk-sharing based finance as a viable alternative to interest-based debt finance. For the Islamic finance industry to achieve its objectives, development of medium-to long-term risk-sharing instruments is an imperative. As the ultimate risk managers of their respective societies, government could design medium-to long-term instruments of risk sharing to finance its own development budget. Government could also develop a second perpetual risk-sharing instrument to finance the remainder of the budget whose rate of return would be a function of the growth of the national income of the country or be tied to the rate of return in the real sector of the economy. These securities – resembling equity shares in a corporation – could be used by the government to convert its debt into these risk-sharing instruments, thus achieving a larger fiscal space. These securities could also be utilized as instruments of monetary policy replacing interest-rate-based government bonds. Importantly, risk-sharing macro-market instruments can provide significant opportunity to individuals, households, firms, and countries to mitigate the adverse consequences of shocks to their economic well-being through diversification.

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[28] Typically, the return generated from the *waqf* fund is used to cover administrative expenses and the surplus, if any, is spent toward the stated purpose. There are also cases in which a certain portion of return is stipulated by the deed to be put in reserve or reinvested to protect against inflation.

With SIBs making new waves in the public finance radar and going mainstream to a projected size between US$60 billion of microfinance and US$3 trillion of venture capital and private equity in the next 20 to 30 years (Cohen, 2014), the Islamic finance industry and the *waqf* sector can recalibrate to improve social outcomes for at-risk individuals. SIB appeals particularly to *waqf* given their complementarity and similar social welfare objectives. For the conventional SIB, *waqf* is an additional and diversified source of capital. For *waqf*, it is a diversification of its investment universe with a double bottom line. The fact that SIB has the support of the government in terms of payment of capital and return on investment contingent upon the success of the social program is positive for the development of the *waqf* sector toward a performance-oriented culture. The evolving SIB ecosystem can well inform the *waqf* sector through, for example, the check and balances in SIB that can strengthen the governance of *waqf* institution. Together with the development of social impact partnerships, the EWF can contribute to the enhancement of human capital and intellectual capital through the nurturing of professional managers, intermediaries, and service providers. Above all, social impact-*waqf* partnerships as well as risk-sharing macro-market instruments would allow for wider participation of the population in the government's initiatives which, in turn, strengthen the connectivity among various stakeholders, social capital, and trust toward public institutions.

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