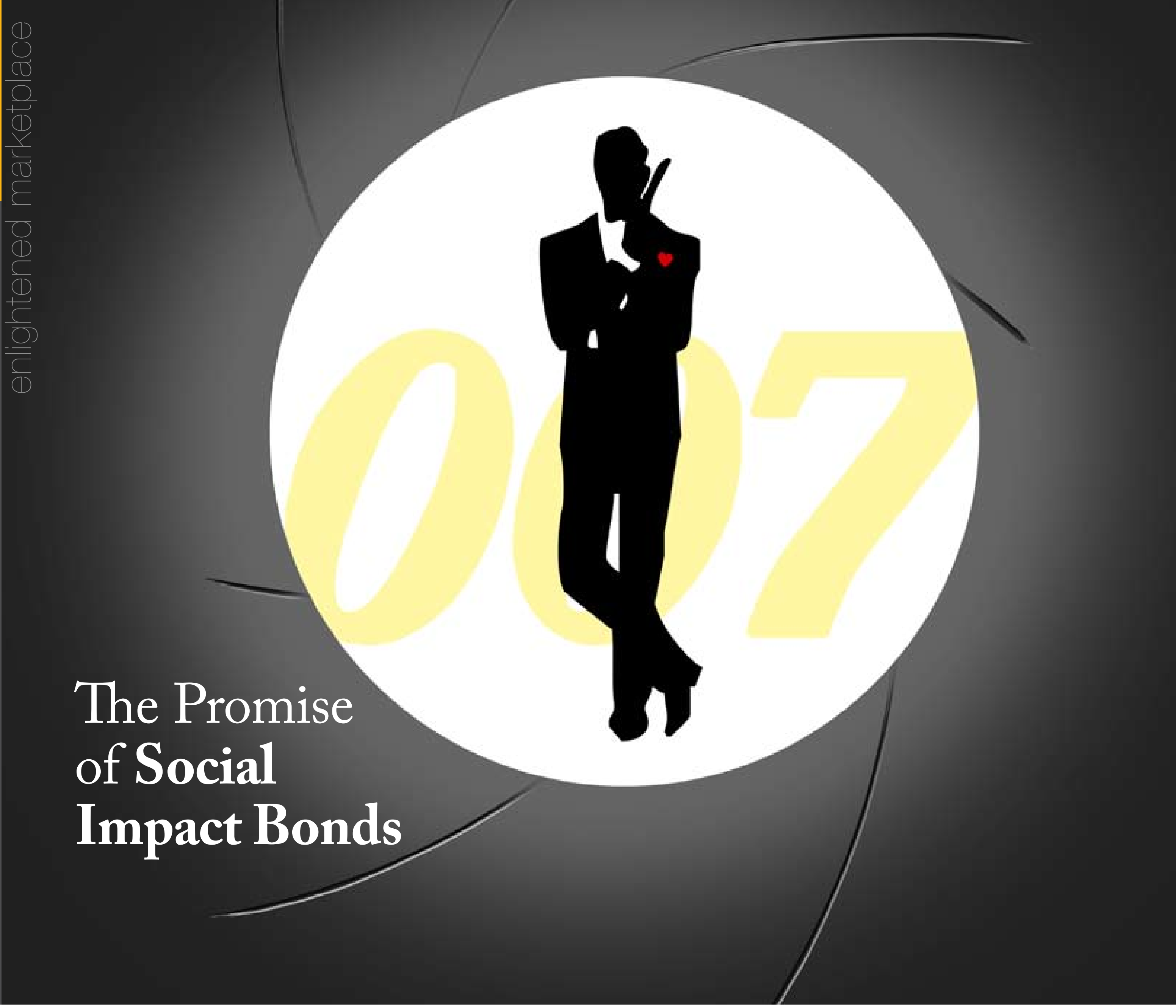

The Promise of **Social Impact Bonds**

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A financial tool from Wall Street is being adapted in the social market to nurture early interventions and incentivise capital flow. As **John Loder** reports, social impact bonds promise two fundamental shifts—for governments to overcome the politics of fear and for private investors to fund social causes with impact.

In a world's first in 2010, the UK's Ministry of Justice teamed up with Social Finance (a company providing financial advisory services) to launch a £5m social impact bond project. Under this scheme, 17 social investors—mainly charitable trusts and foundations—fund upfront the cost of social services for some 3,000 short-sentence Peterborough prisoners.

The investors carry with them the expectation that these social services will lead to a decrease in the re-offending rate by at least 7.5%.[1] If re-offending rates fall by that percentage or higher, the Ministry, supported by the Big Lottery Fund, will pay the investors between £5m and £8m.[2] If the percentage is lower, the investors absorb the cost of the programmes. The scheme will run for six years.

The hope does not end there. If the project is successful,[3] a second tranche of bonds worth £50m will be released by Social

Finance with the goal of closing four prisons within five years. The net savings to the government is projected at around £62m.

The Evolution of Social Impact Bonds

Over the last few years, interest has grown in developing new investment approaches to social problems. Actually realising this interest has been difficult, but four developments accelerated thinking during the early 2000s:

- Greater interest on the part of investors and philanthropists in combining commercial and social returns.[4]
- Steady advances in assessing the impact of public investments on social outcomes such as crime reduction or health improvements.[5]
- Widespread experience of incorporating private finance into public investment, such as the Private Finance Initiative in the UK, with a growing expertise on when these do and do not add value.
- A growing track record of significant impacts achieved by innovative financing structures, for example, the development of markets for carbon reduction, prompted by the Kyoto Protocol and the European Union.

Against this background, in early 2008, the Prime Minister's Council on Social Action,[6] led by banker and Young Foundation Chairman Peter Wheeler, began work to identify new types of investment vehicles for social outcomes. This work was based on two central insights:

- First, socially valuable initiatives often also have positive long term financial consequences. For example, working with ex-prisoners to help them commit fewer crimes can have huge savings in terms of future prison costs. The cost of a year's imprisonment is more than the cost of a year's tuition at one of Britain's most exclusive private schools.
- Secondly, despite this economic potential, the institutions who can create these benefits cannot find the funding to do so.

This was a situation that cried out for a financial solution which eventually led to the development of the Social Impact Bond, or SIB. Essentially, an SIB is a financial instrument that raises capital and links financial returns to the achievement of a particular socially desirable outcome.

SIBs have the potential to bring in fresh sources of financial capital, to focus attention on preventive action, to promote innovation by transferring risk away from government, and to provide new funding for civil society organisations that face government funding cuts. Some of the work to realise this potential had been undertaken by Social Finance, which agreed on the terms of the first SIB in the final days of the Labour government in early 2010.

The Young Foundation coined the term "Social Impact Bond," and fed into Social Finance's work while also developing alternative models of SIBs, all of which shared the goal of turning social outcomes into investments to encourage the creation of more good for less money.

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What is a Social Impact Bond?

SIBs typically involve three elements:

- Monetary investment (for example from commercial investors, philanthropists or foundations);
- A programme of actions to improve the prospects of a group (for example, a support and mentoring service for those leaving prison with the aim to reduce re-offending); and
- Commitments by national or local government, or foundations, to make payments to the investors that are linked to improved social outcomes achieved by the group (for example, re-payment of the original investment and an extra percentage agreed return on investment. Reduced costs to the Ministry of Justice are achieved through a reduction in the number of re-offenders in prison). Typically, payment is proportional to impact; if there is no impact, there is no repayment.

Consequently, there are three roles in a typical SIB scheme—the investor who supplies the capital, the operator who uses this money to run a socially useful programme, and the payer, usually government, who pays out if outcomes have been met.

The investor is likely to be, initially, at least, a philanthropic foundation and government branch. In time, it is hoped the SIBs will develop into a mature asset class that can attract a broader commercial investment. However, this is likely to be some years away. For now, the operator tends to be a non-profit, a governmental body such as a local authority, or a consortium containing both types.

SIBs are most likely to be of use in areas where a single outcome can provide both social and economic value. Criminal justice provides one such area, where a fall in the reoffending rate is both economically and socially desirable. Providing the support necessary to allow elderly people to live independent and active lives, rather than fall into residential care, is another area of high potential. Indeed, an SIB was announced in Australia in March 2011 to focus on these two areas, along with high risk families.

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	Social Impact Bonds	Outcomes-based contracts	Government debt
Public sector only pays for success	✓	✓	✗
Risk that interventions do not improve outcomes is transferred away from the public sector	✓	✓	✗
Additional non-government finance is provided to improve social outcomes	✓	✗	✓
Public sector payments are proportional to the improvement in social outcomes Environmental integrity	✓	?	✗
Service providers' costs are funded up front	✓	✗	✓
Facilitates cooperation between multiple service providers	✓	?	✗

> SIBs potentially provide a systematic, evidence-based way of scaling up schemes that work well, while **promoting a culture of innovation**.

A Comparison with Other Government Finance Tools

If a comparison needs to be made, the preceding chart from Social Finance's 2010 report "Towards a New Social Economy" sums up the key defining characteristics of SIBs when compared with outcomes-based contracts and government debt. Unlike the latter two finance tools, an SIB enables payments to be made based on the degree of impact while facilitating cooperation between multiple service providers.

Differentiators of an SIB

It should be noted that SIBs are about more than just extra capital. After all, the state could invest in the same solutions that are being funded here, at lower capital costs, and with minimal transaction costs. Therefore, to justify themselves, SIBs need to show that they can channel this capital more efficiently and with better outcomes than ordinary state expenditure could. There are several reasons why they should be expected to do this.

First, SIBs provide better incentives. Until recently, incentives for social interventions have often been based not on outcomes, but on activity. A social organisation might be paid for its time working with unemployed teenagers, rather than on whether that results in the teenagers finding work. SIBs incentivise based on outcomes, and will lead to a sharper focus on what works.

Secondly, SIBs can match incentive and capability. This is often a problem for large state institutions. Those parts of the institution that have the capability to affect an outcome may not have the incentive to act. Examples from inside government include:

- Local authorities or NGOs responsible for providing services to young people do not share the benefits from reductions in prison numbers or benefits bills.
- There are few incentives for agencies to invest heavily and support the development of new preventive measures or programmes, despite strong evidence about the long-term social gains.
- Health promotion or prevention of unhealthy behaviour often involves action by agencies such as schools, the long term benefits of which accrue to the health sector. But these are not success indicators with which schools are rewarded.

There are strong grounds for believing that there is systematic under-investment in effective prevention of social problems.[7] SIBs fill the gap by functioning as a link between one part of government and another, for example between local and central government, or between a national health system and the schools system. It provides a framework or a mechanism for otherwise disparate actors to look at the issues as part of a wider system.

For SIBs that bring in non-state institutions such as operators and funders, there are additional benefits.

For starters, SIBs provide space for risk-taking innovation. Large institutions typically find it hard to encourage appropriate innovative risk-taking internally. Innovation is often no one's remit, and it's disruptive to existing practice and interests. As Keynes said, "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally." Political considerations magnify this issue in government; failures may be excoriated in the press, while successes often go unsung. By its nature, innovation is risky and the cost of failure may be, politically, too high a price for those within existing institutions.

SIBs allow someone other than government in its commissioning role to bear the risk of social programmes. If outcomes are not improved, government does not pay out. Instead, the risk sits with those with an appetite for it, and the means to make that project a success.

Of course, such an approach requires a careful and accurate measurement of the relevant outcomes. This builds a body of understanding about the most effective methods for dealing with social problems that often arise in fields where high quality evidence is hard to find.

Finally, an innovative system requires a pathway whereby successful ideas demonstrate their effectiveness, and are applied on a wider scale. Innovative solutions have little value if they are not implemented, and the incentive to develop them is diminished when implementation is difficult. In the social sector, funding to scale up is usually scarce. Many innovative institutions, funded by donors, operate at a small scale. Further, charitable donations are not likely to be sufficient for even a regional roll out of an idea; instead, government funding is necessary.

Yet, getting the attention and resources of government is uncertain. Institutions with a charismatic representative, strong marketing, an appealing client base and good timing may find themselves part of a prominent government initiative that is rolled out very quickly. In some cases, this roll□out outpaces institutional capability, and the promising effects of the pilot are not repeated on a wider scale. Other equally effective institutions may find even maintaining funding, a continuous struggle and a wider roll□out, a distant aspiration.

SIBs potentially provide a systematic, evidence-based way of scaling up schemes that work well, while promoting a culture of innovation. They allow government to take full advantage of the grass roots innovation that is going on by trying out a number of different solutions with managed risk. Further, funders are incentivised to moderate the speed of roll-out, so that it does not outpace the capacity of the organisation.

Challenges in Implementation

Despite the significant potential benefits of SIBs, there are also challenges that need to be worked through. The most technically complex issue is how to measure the impact fairly. Funders and government must be confident that the metric used in an SIB is a reliable and unbiased yardstick of performance. This issue can be thought of in two parts.

The first task is to establish that the outcome has changed as a result of the intervention, rather than for some independent reason. An SIB based on reducing reoffending must be able to show that fewer crimes are committed due to the mentoring of prisoners, rather than an improvement in the economy, or a change in the legal environment. This issue is not unique to SIBs, but is common to most studies in social science, and there is a well established methodology associated with it and for dealing with appropriate control groups, selection bias, statistical confidence levels and so on.

The second task is to show that changes in the outcome produce savings. This is a less well developed area, and is worth commenting on briefly.

First, a minimum scale of impact may be necessary to release savings. For example, to save on prison costs, a prison wing may have to close before government achieves any actual savings. To manage this risk, SIB partners should ensure the process of making savings is clearly agreed on at the beginning of the SIB. There also needs to be a mechanism whereby the scale of the SIB can be tweaked if

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the impact proves to be insufficient to achieve actual savings for government.

Secondly, diffuse benefits can also be an issue. It may be difficult to collaborate across local and central government to address where the multiple benefits should fall. For example, less reoffending has a large direct savings for a country's ministry of justice, and it is thus relatively easy to allocate the savings.

On the other hand an initiative working with the most deprived and chaotic families might bring benefits across justice, health, education and housing. It might also increase costs to some parts of government, as these families access services that they have previously not used, such as primary healthcare and training. Allocation of these cost and benefits can be excessively complex. SIBs will work best where a costs and benefits can be clearly allocated to one or two institutions.

Thirdly, there is a need to consider the effects of the intervention on the wider system. In our criminal justice example, a successful programme will result in fewer crimes being committed by our target group, and fewer prison places being occupied. It will also free up the police time that

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would have been spent pursuing these groups. However, the police may use the additional time to arrest a different set of criminals who will, in turn, fill prison places. Thus, not all the potential savings will be realised. Returns from SIBs need to be high enough to absorb some allowance for this knock-on effect.

Fourthly, a key challenge for SIBs is to ensure they do not displace existing spending and interventions by incentivising existing funders or providers to cut spending or provision. This is particularly challenging where considerable overlaps exist with existing public provision. In trying to better align incentives, SIBs risk creating new misalignments. To manage this risk, SIB partners can include existing providers in the SIB as partners, ensuring that they have a strong incentive to make the SIB work, and/or reach agreement with existing providers to maintain current levels of spending or programme delivery.

Structural Deficiencies to be Rectified

For the considerable potential of SIBs to be realised, a number of developments are necessary.

First, much of the detail of the structure remains to be worked out. Necessary returns, measurement rules, payment timings, and legal structures are all uncertain at this point. The answers to these questions will only come from experience.

Secondly, this experience needs to be translated into standard contracts and structures, in order to minimise transaction costs. High transaction costs were one of the issues that bedevilled private finance initiative funding in the UK, meaning that contracts needed to be very large to be economic. SIBs are not designed for expensive operations such as building hospitals or housing, but for social interventions. They will require low transaction costs to work.

Finally, there is a need for intermediaries who can negotiate and manage SIBs. In their most extensive form, SIBs will involve the management of complex negotiations across three different realms—the public, private, and the social. As these all have their own specialist language and culture, the scope for misunderstandings and loss of momentum is considerable. Strong relationship management skills are vital, so that the perspectives and concerns of the different realms—from policy maker to social entrepreneur, from financier to public service commissioner—can be taken on board and made intelligible to all the parties involved in creating an SIB. Such a blend of requirements is not straightforward to deploy. However, a number of organisations across the world is developing this range of skills, either together, or in alliances, and we expect the supporting industry to develop steadily.

Conclusion

SIBs are now being considered in many parts of the world as a viable social tool, including the US, Australia and Europe. Their apparent simplicity is clearly appealing, even if their execution is likely to be more complex.

They have considerable potential to improve social outcomes by aligning incentives, providing space for risk and innovation, and promoting evidence-based policies. Much of the detail remains to be worked out. Our hope is that a range of variants will be tried, tested and evaluated over the next few years with maximum openness on methods, legal forms and results. Some of these experiments will fail, but others will succeed. Given the high levels of activity and interest in SIBs internationally, we expect them to evolve quickly, with variants becoming a mainstream financing instrument.

1. This percentage fall is compared to a control group of short-sentence prisoners in the UK.

2. Investors receive an increasing return capped at a maximum of 13% per year over an eight year period.

3. At the time of writing, it's still too early to get any sense of how it's progressing.

4. Geoff Mulgan, "Measuring Social Value," *Stanford Social Innovation Review* (August, 2010) provides an overview of the many methods for assessing value, as well as suggesting how these can be made more useful, http://www.ssireview.org/articles/entry/measuring_social_value/.

5. For example, see the recently launched journal *Evidence & Policy: A Journal of Research, Debate and Practice* (The Policy Press).

6. A group of innovators from every sector brought together to generate ideas and initiatives through which Government and other key stakeholders can catalyse, celebrate and develop social action.

7. "Early Intervention Key to Crime Prevention, MPs Say," www.parliament.uk, 23 March 2010, http://www.parliament.uk/business/news/2010/03/early-intervention-key-to-crime-prevention-mps-say/.