THE FEASIBILITY AND FUTURE OF SOCIAL IMPACT BONDS IN THE UNITED STATES

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Abstract

Social Impact Bonds were recently introduced as a new, innovative way to strengthen social service delivery, improve government spending, and develop impact measurement. While there is potential for this structure to be effective, the excitement surrounding this innovation needs to be managed to provide ample space for experimentation and failure. Without setting reasonable expectations, this product will disappear as quickly, and with the same fervor, as it arrived.

Impact investing, the concept of leveraging private funds for a blended social and financial return, has become a hot topic in the world of social impact and entrepreneurship over the past few years. Collaboration and interest among large banks, foundations, governments, private investors, universities, and venture funds have elevated the field, which has set the stage for the creation of a more supportive financing ecosystem for social entrepreneurs.

Under the impact investing umbrella, one new vehicle that has garnered attention is the social impact bond (SIB), launched in the UK in September 2010. This structure, which is only a bond in name, raises private capital to fund social interventions focused on prevention instead of cure to create government savings. While many countries are experimenting with SIBs, this paper will focus on the steps the US needs to take to lay a strong foundation

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for the successful implementation of social impact bonds.

SIBs have the potential to shift the government funding cycle, creating a system centered on prevention and measurable outcomes instead of one focused on remedial interventions and inputs. This market-driven solution to the inefficiencies found in government spending and social services, if successful, could catalyze large-scale social change.

But SIBs are far from a silver bullet. There are many challenges that need to be addressed before SIBs can be implemented effectively.

While challenges and risks exist in all links of the SIB value chain, the four core issues are:

- Managing public expectations and creating space for failure,
- Attracting commercial capital,
- Identifying “SIB-ready” social services and providers, and
- Preparing the ecosystem to enable the adoption of a new contract type.

As the players in the US attempt to create social impact bonds in a domestic context, they will need to innovatively attack these barriers to unleash the potential of this new financing structure.

The Social Impact Bond

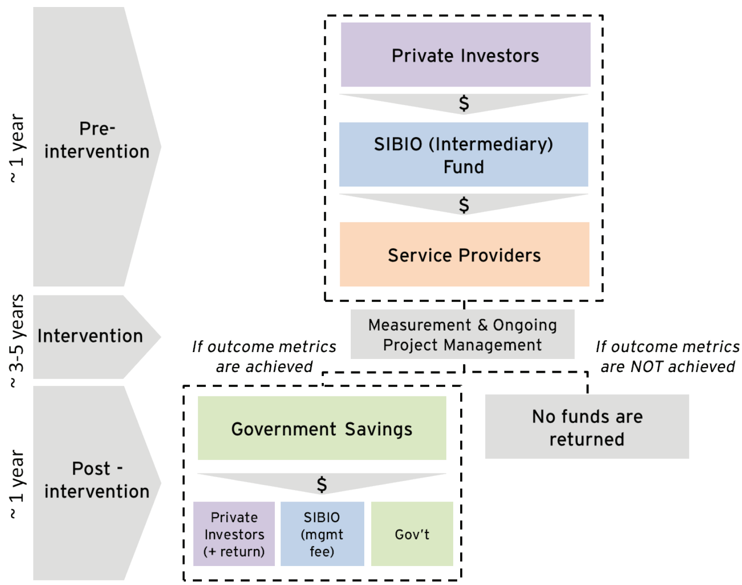
Social impact bonds were created to identify and scale proven social interventions to serve vulnerable populations in a more cost-effective way, something that existing systems fail to do. Currently, the only actor incentivized to provide effective social interventions is the government, but it does not have the resources or risk tolerance to find and scale the right social intervention models. The SIB structure was created to address this gap.

SIBs align the interests and incentives of all necessary actors to create an ecosystem that allows for social innovation, measurement, and widespread adoption.

The relationships and cash flow between each entity are described in Figure A. Before any money is allocated, concurrent contracts are written between the intermediary (or the Social Impact Bond Intermediary Organization, the SIBIO) and four parties: the investors, the affected government agencies, the service providers, and a third party evaluator. The main provisions of the contracts will define:

- The social problem they are trying to address,
- The service model(s) with which to address it,
- The outcome and output metrics they would like to achieve,
- The measurement of outputs and outcomes,
- The relationship between the outcomes and public savings (dollar amounts), and
- The allocation of government savings when realized.

Figure A



Once the terms are finalized and the contracts are established, private investors commit capital to the SIBIO, allowing them to draw down funds over the life of the intervention period. When drawn, the funds go through the SIBIO to the participating service providers to fund the interventions. At the end of the defined intervention period, if the interventions are successful, the government savings are split between three parties, (1) the government agency, (2) the investors (who get both their principal plus an agreed upon annual rate of return), and (3) the SIBIO, which gets a management fee for structuring the deal and providing oversight throughout the life of the SIB. If the intervention does not achieve the agreed upon outcomes, the investors are not repaid.

While various SIB structures may exist in the future (see Appendix A for a list of SIB activity around the world), the Peterborough Social Impact Bond, named for the HMP Peterborough Prison in the UK, is the only one currently on the market.

The only SIB on the market: The Peterborough Social Impact Bond

Social Finance in the UK, the organization that created and launched this fledgling product, decided that the first social ill they wanted to attack was adult recidivism among short-sentence prisoners. They saw both a problem – 60 percent of male prisoners released were reoffending within one year – and an opportunity, as these prisoners were not receiving any support upon their release. Social Finance, as the intermediary (or SIBIO), gathered the necessary parties to sign the first SIB contract in 2010.

The story of the SIB structure is more easily told through the eyes of each participating party.

i. *The Service Providers: The ONE* Service*

The ONE* Service is a coalition of service providers, including St. Giles Trust, Ormiston Trust, and the YMCA (among others), which have had success in helping recently released prisoners reenter society effectively in different phases of the reentry life cycle. While their interventions work, they lack the capital and flexibility to scale their operations and impact. The upfront, guaranteed capital over the life of the SIB provides them with the flexibility and incentive to provide their services most effectively – and in coordination with each other.

ii. *The Public Agencies: The Ministry of Justice and the Big Lottery Fund*

The Ministry of Justice is the government agency that will accrue savings if the interventions prove effective. If the ONE* Service team is able to reduce the reoffending rates of short-sentence prisoners, the money saved on these prisoners – in the form of reductions in the prison stay itself, the legal costs, and the law enforcement resources – can be reallocated. The Big Lottery Fund also signed on to help the Ministry of Justice make these payments should the interventions prove successful. These public entities get both improved social outcomes and public savings, without having to pay for the risks associated with scaling.

iii. The Intermediary/SIBIO: Social Finance

Social Finance is a non-profit financial institution founded in 2007 that created the SIB structure. To run the operations of the Peterborough SIB, it created a separate legal structure called the Social Impact Partnership, which is the Social Impact Bond Issuing Organization for the Peterborough SIB. Success is important for Social Finance for two reasons, (1) to implement more SIBs in the future (and thus create a larger impact), it needs to prove that the model can be successful, and (2) it receives a fee for managing the project. For the organization to be self-sustaining, it must structure and manage multiple bonds concurrently to bring in the necessary income.

iv. The Private Investors: Foundations and High-Net-Worth Individuals

There are seventeen private investors in the Peterborough Bond. The majority are foundations and high-net-worth individuals. These investors stand to gain socially by leveraging their capital to provide better support to vulnerable populations. They also stand to gain financially from the agreed-upon annual return if the SIB is successful. In addition to the return, this structure is attractive financially because it is not correlated with traditional asset classes and can therefore reduce overall portfolio risk. In the case of the Peterborough project, investors can receive up to a 13 percent annual return on their investment, but stand to lose everything if the interventions fail. While this project's return was attractive for these foundations and individuals, the ability to attract commercial capital remains uncertain.

v. The Measurement Organization

In order to determine the effectiveness of the model, a reputable third-party evaluator must track and measure the success of the interventions. If the outcome metrics are hit, the investors get repaid their principal along with an annualized return. If not, the investors lose their investment. The organization that acts as this independent assessor enters into a contract with the intermediary and is paid for its services.

vi. The Target Population: 3,000 Recently Released Short-term Prisoners

The population receiving services needs to be clearly defined so the service providers cannot cherry-pick a population that is most susceptible to reform. There also needs to be either a control group or a projected baseline with which to compare the improvements. In the case of the Peterborough SIB, the interventions are focused on 3,000 male, recently released, short-term prisoners. The control group is a similar group of short-sentenced male prisoners across the UK pulled from the Police National Computer[i]. The target population benefits from better support given by well-resourced social service providers who care about the recipients' future and success.

The Peterborough Social Impact Bond completed its first year in November 2011. While the first year's report showed progress and anecdotal impact, there are three more years of intervention before any results are calculated and reported. However, other countries and jurisdictions are not waiting for the results; they are moving ahead with their own experiments, as evidenced by the activity and excitement in the US.

Social Impact Bonds in the US

The social impact bond concept was introduced in the US in 2011 under two names. The Fiscal Year 2012 Federal Budget released by the Obama Administration included funding for a similar structure, but called them "Pay for Success" bonds. A few days after the Budget was released, a Social Finance office was opened in Boston and expressed its intent to create Social Impact Bonds across the US.[ii] Since 2011, there have been numerous states and cities intrigued by this model and attempting to develop their own SIBs. As of the writing of this paper, it appears that Massachusetts will be the first state to conduct a SIB, with other states, such as New York, Minnesota, Rhode Island, and California, close behind.

SIBs are needed in the US to shift the government funding cycle

The public sector in the US, much like the UK, is stuck in a spending trap that focuses on emergency interventions. This leaves minimal public dollars available for prevention or early intervention spending that would reduce the costs to both the government and society. SIB models in the US are meant to address this "negative spending cycle."[iii]

There are two main reasons why this funding trap exists in the US: (1) early interventions are risky and typically require large amounts of up-front capital to implement, a risk that the government is not willing to take with tax-payer dollars; and (2) spending focuses on inputs instead of on measurement of results to decide where funding is best spent.[iv] This translates into government spending that is reactionary, unplanned, and often wasted on interventions or services that are unproven and do not work.

Social Impact Bonds are intended to: inject private capital into social service providers to absorb the risk needed to discover and scale proven interventions; increase the integrity of non-profit data collection and metrics through competition for funds; measure the success or failure of these programs; and prove and collect government savings to return to investors, all while creating a learning laboratory for the government to adopt the best programs to grow and scale.

Pay-for-Performance models in the US have set a foundation from which to launch successful SIBs

While the SIB structure was considered new when announced, the backbone of the SIB structure, the pay-for-performance contract, is not as novel. The history and success of pay-for-performance programs have helped pave the way for the social impact bond model to gain broad acceptance in the US, and they provide strong examples for interventions that may work well within the SIB structure.

Pay-for-performance programs have gained traction in the past decade as local, state, and federal government budgets search for ways to improve services while maximizing cost effectiveness. While the majority of these programs have resided in the health care delivery and prevention field, others are finding innovative ways to put quality, evidence-based mechanisms to work in other service areas to save scarce government resources.

The state program that seems most closely aligned with the Social Impact Bond concept is the Maryland Opportunity Compact founded in 2005. The Compact solicits private investment for seed capital to implement a new program, proves the program works and saves public dollars, then reinvests the savings to expand the program to broaden its reach. While the model is slightly different from SIBs because the investors provide grants without an expected return and the savings are recycled back into the programming, the motivations are aligned. The Compact website states that it "aims to break the inefficient cycle of last resort spending by targeting resources to proven strategies that strengthen vulnerable families, move them to self-sufficiency and prepare them to lead productive lives, all while saving tax dollars."[v]

The Introduction of US SIBs, the "Pay for Success" bond

The Fiscal Year 2012 and 2013 Budgets released by the Obama Administration included $100 million and $109 million, respectively, for Pay for Success (PFS) bonds. The FY 2012 budget introduces the PFS structure, stating that it is "designed to promote innovative strategies to reduce the aggregate level of government investment needed to achieve successful outcomes and impose minimal administrative requirements on service providers, so as to allow for maximum flexibility to improve efficiency and effectiveness."[vi] The language in the provision also emphasizes the contractual specifications needed in future funding awards, including:

- Disbursal of public funds only after outcomes have been achieved,
- Objective outcome-measurement methodologies,
- Payment schedules based on the estimated return on investment and the probability of achieving benchmarks,
- Use of funds for other Pay for Success projects should some fail to meet outcome criteria[vii]

The FY 2013 budget language shows the progress that was made over the last year:

> "Over the course of 2012, the Administration is launching a small number of Pay for Success pilots in criminal justice and workforce

> development. The President's 2013 Budget reserves a total of up to $109 million to test this new financing mechanism in a broader range of areas including education and homelessness. If successful, Pay for Success projects offer a cost-effective way to replicate effective practices and support continuing innovation as Federal resources become more constrained."[viii]

With limited state and federal budgets, there has been excitement and enthusiasm around SIBs/PFS structures from both sides of the aisle, but despite the momentum and push from the Administration, the funding was not included in the federal budget written in Congress for FY 2012. It remains unclear whether it will be included in FY 2013.

Understanding and addressing the key challenges

While the social impact bond model has been well received since its introduction in the US, there are still major barriers to setup and implementation. The four main challenges are:

- Managing public expectations and creating space for failure,
- Attracting commercial capital,
- Identifying "SIB-ready" social services and providers, and
- Preparing the ecosystem to enable the adoption of a new contract type.

While these present barriers to adoption, they are not insurmountable. With each challenge, there are potential solutions that can help mitigate the risks involved.

Managing public expectations and creating space for failure

The most important challenge is managing the expectations of the first few SIBs in the US. The excitement around this new product has brought with it a heightened level of scrutiny and pressure for it to succeed – and succeed quickly.

But this is not a structure that can be launched overnight. Gaining buy-in from the government, investors, and service providers will take considerable time and energy from the SIBIO, which plays the convener and moderator role in this process. Once all parties understand the risks involved, writing the contracts will take months of negotiation to get all parties to agree on the parameters. In the UK, this process took at least a year to complete. Once the contract is signed and the SIB is officially launched, there is typically a year allowed for setup, three to five years of intervention, and a year of evaluation and wrap-up. Patience will be required should the first (or first few) SIBs fail to hit their predetermined metrics so that the model is not struck down before it has a fair chance to prove its potential.

Transparency and information flow will be critical. Organizations like the Nonprofit Finance Fund and the Rockefeller Foundation, which have set up an unbiased "learning hub" for SIBs, can help by releasing periodic reports on the progress of the SIBs operating across the country. These reports would offer a realistic snapshot of the work, highlighting the day-to-day challenges of providing these services. The hope is that with this information widely disseminated, judgments will shift from a binary choice of success or failure to a more nuanced assessment. If the question can be reframed from "does this model work?" to "how can we learn from early failures to refine and improve the model?" SIBs will have a much better chance at long-term success.

In the end, it is the responsibility of all parties involved – particularly the intermediary, investors, and government agencies – to remain cautiously optimistic about the potential of the SIB and manage the expectations of other stakeholders to limit disappointment should the SIB fail.

Attracting Commercial Capital

The SIB structure relies on the availability of commercial capital to open the social services market to a much larger source of funding than is currently accessible to nonprofit organizations. Without this new influx of private capital, the only innovation is the outcome measurement and reward, a combination that has already been introduced in the US through aforementioned pay-for-performance contracts.

In the Peterborough SIB, foundations and high-net-worth individuals stepped in to play the investor role. While there is a budding interest among social investors in vehicles with blended returns, the amount of money from individual investors and foundation program related investments (PRIs) in the US is inadequate.

- Individual Investors. A Hope Consulting report that surveyed individual investors to gauge interest in "impact investing" showed that 45 percent of respondents were interested in "investment with a social bonus," and 35 percent were interested in a "business solution to a social issue." Both could be used to describe SIBs. But when asked how much they were willing to invest in this space, 95 percent of respondents said less than $25,000.ix These results do not indicate a current willingness of private investors to put the necessary amounts of money into a long-term SIB contract.

- Program Related Investments (PRIs). While foundations are starting to look more closely at PRIs, the PRI market is still fairly small. According to the Foundation Center, foundations made $310.5 million in PRIs in 2006, but the majority of this was concentrated in a few major foundations.x Foundations are generally wary of using PRIs because the funds are tied up for a long period of time, increasing the risk of default or loss. The current scarcity of PRI activity does not provide much hope for large-scale foundation involvement in SIBs, unless one of the major foundations, such as Rockefeller, Gates, or Ford, decides to take the lead to help prove the model.

The current structure relies on these sources of capital because of the risk of full principal loss. Because of this risk, the SIB is not an attractive vehicle for private, commercial investors. Any structure developed in the US needs to mitigate this risk in order to make the first SIBs attractive to commercial investors and to set the precedent for future interest by institutional impact investors.

Potential ways to protect the principal of the investment include:

- Creating a separate, grant-raised loan loss reserve to act as a principal guarantee should the SIB intervention fail.
- Layering the capital structure of the SIB to leverage the different intents of the investors. For example, a foundation could provide the "base/first loss" layer, high-net-worth impact investors could provide the second layer and accept lower returns, while commercial investors could provide the final, preferred layer and receive returns with a reduced risk.
- Bundling the SIBs into a mutual fund-type instrument once the market starts to grow so the risk can be diversified across multiple

projects.

If SIBs are to reach their potential scale and impact in the US, commercial viability is essential. All efforts should be made to construct the SIB in a way that is feasible for prudent investors to place money into this structure.

Identifying "SIB-ready" Social Services and Providers

As seen in the UK and through potential interventions in the US, not all social ills can be solved through SIBs. There needs to be a clear problem, identifiable control group, measurable outcomes, and easy-to-define, short-term savings generated for the government to make these work. Therefore, choosing the first interventions in the US on which to test the model is extremely important to prove to investors, public officials, and the general public that the model is feasible.

The federal government and the Massachusetts government, the two entities that are pushing for SIBs in the US this year, have chosen the following intervention areas that they think fit these criteria:

- Criminal justice (juvenile and adult)
- Workforce development
- Homelessness
- Education

The federal government is focusing on all of these interventions, while Massachusetts has zeroed in on homelessness and juvenile justice. These interventions – and their potential to become strong SIB programs – are evaluated along a matrix of required elements:

Field of intervention	*Problem definition*	*Desired outcome*	*Target population*	*Output or Outcome metrics*	*Potential for returns*
Workforce development	Un- and under-employment of US workers	Increased full time employment, higher wages and quality benefits	The un- and under-employed in a certain region	Jobs, wages, quality and type of benefits, hours worked per week	Yes, large savings from reduced unemployment insurance and other welfare benefits

Field of intervention	*Problem definition*	*Desired outcome*	*Target population*	*Output or Outcome metrics*	*Potential for returns*
Homelessness	Chronically homeless individuals who rely on a large number of "cure" social services	Permanent housing and access to necessary health care	Chronically homeless individuals, mainly in US cities	Placements in permanent housing, Medicaid spending, ER visits	Yes, large savings from more efficient health care delivery and reduced costs from temporary housing
Juvenile Justice	Juvenile offenders who are more likely to spend part of adulthood in jail	Reduced recidivism rates for juveniles and successful reentry into society	Recent or soon to be released offenders in a certain region	Reduced recidivism rates, employment and education rates	Yes, savings from variable per-prisoner costs, law and enforcement costs, and eventually closed cells/ prisons
Education	Lack of quality public education that is not adequately preparing students	Higher achievement levels and outcomes for K-12 children	K-12 children in public schools	Test scores, HS and college graduation rates, employment rates, income levels	Yes, but long term and harder to track and attribute to one intervention.

Of these, education faces the greatest challenge because using student educational interventions for the initial SIBs could invite controversy over metrics and outcomes that might raise legitimacy claims about the model.[xi] The constant debate on how to measure educational achievement and teacher quality could distract from the core ideas of the SIB structure. Therefore, education is better addressed after the model is proven through less politicized interventions.

Preparing the Ecosystem

Currently, most budgeting contracts from the state or federal government do not span more than one year because of appropriations laws. As the law stands, most funds are only made available to agencies for a one to two year period, and if unused, they automatically get re-routed to the Treasury Department.[xii] If sufficient funds cannot be allocated by the government over the longer-term life of the SIB, investors will perceive more risk in the future cash flow, undermining the effectiveness of the structure.

In order to facilitate longer-term contracting and provide a level of comfort for the investors, one of two changes needs to occur. One option is to pass "full faith and credit" legislation at the state and federal level to allow for contracting that can promise funding in five to ten years' time, should the intervention prove successful.

Another option is for each department that receives Pay for Success funding to amend their appropriations language to provide an exception to the law as currently written. The new law would include a statement that "any funds obligated for such projects shall remain available for disbursement until expended, notwithstanding 31 U.S.C. 1552(a)", which states, "Provided further, any de-obligated funds from such projects shall immediately be available for Pay for Success projects."[xiii] In order to attract investors, these changes should be implemented before SIB contracts are written with federal or state dollars.

The second infrastructure requirement is the level of measurement and data analysis of participating service providers. The SIB model depends heavily on identifying providers that can implement an intervention to create the intended, measurable outcomes that will translate directly into government savings. This requires sophisticated tracking, measurement, and data collection that is not typically found in non-profit organizations. Past studies have shown that most non-profit organizations, even those who claim to have a focus on outcome measurement, do not have the sufficient infrastructure in place to effectively measure their impact.[xiv]

While not all non-profits are inept at measuring outcomes, for the SIB model to succeed, they must place more emphasis on outcome measurement, reporting, and standards. This is particularly important for the initial bonds created, as proven interventions with solid data will be essential to raise private capital.

Model and Intervention Risk

The risks highlighted above are specific to SIB adoption and implementation in the US, where social impact bonds do not yet exist. In addition to these categories of risk, there are multiple risks associated with the model itself, including assumptions that:

- The intervention works as intended and produces the agreed upon outcomes,
- The control group remains untouched and reliable as a counterfactual,
- The government, private investors, and service providers agree upon metrics so the savings can be accurately calculated and

allocated.

- These risks are inherent to the structure and will be a factor regardless of location.

Conclusion

Innovation in social services and government spending is rare, which is why Social Impact Bonds have attracted interest and garnered so much attention from different stakeholders. This structure, developed by a small organization in the UK, has the potential to change how public agencies and service providers interact and measure their success.

In addition, the excitement around the field of impact investing has caused the SIB structure to spread like wild fire and created a daunting space for itself under a global magnifying glass.

At the end of the day, the social impact bond is complicated and requires a lot of large, embedded systems to coalesce around its structure. Because of these challenges, there needs to be sufficient caution around its potential to achieve large-scale change, its ability to attract commercial capital, the availability of relevant social services, and other barriers to implementation until the model is proven.

In order for the US to create a supportive environment for these bonds, the following steps need to be taken concurrently:

i. *All parties involved need to manage expectations around the timeline and potential impact of this product and suspend judgment until multiple SIBs have succeeded. Transparency and constant communication is critical to achieving this goal.*

ii. *The structure of the product needs to mitigate the risk of full principal loss through a guarantee or first loss pool to attract and comfort commercial investors.*

iii. *The intermediary and government need to be selective about which interventions will work with the model, focusing on proven social interventions in homelessness, juvenile justice, and workforce development that provide short-term, realizable public savings from an easily identifiable population and can be scaled effectively.*

iv. *The state and federal government need to pass or adapt appropriations* *laws to allow for a long-term contract with the intermediary, reducing the risk to future cash flows.*

v. *Social service providers need to develop more robust measurement procedures to prove they are capable of achieving and proving the desired outcomes.*

If these steps are taken, SIBs will have a much greater chance of success at achieving their potential for large-scale social impact in the US.

Appendix A: Global activity of Social Impact Bonds

United Kingdom

Agency/Government	*Intervention Focus*	*Launch or Announcement Date*
UK Department of Justice	Adult recidivism	November 2010
Manchester City Council	"Looked after" children and young people (foster children)	March 2012
Greater London Authority and Department of Communities and Local Government	"Rough sleepers" (chronically homeless)	March 2012
Scotland's Department of Work and Pensions	At-risk youth	March 2012

Australia

Agency/Government	*Intervention Focus*	*Launch or Announcement Date*
New South Wales	Juvenile justice, families at risk, disability services	March 2012

United States

Agency/Government	*Intervention Focus*	*Launch or Announcement Date*
Massachusetts State government	Adult recidivism	November 2010
Manchester City Council	"Looked after" children and young people (foster children)	March 2012
Minnesota State government	"Rough sleepers" (chronically homeless)	March 2012
New York City government	At-risk youth	March 2012

Endnotes

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