Pay for Success: Building On 25 Years of Experience with the Low Income Housing Tax Credit

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Pay for Success (PFS) has been touted as the hot new innovation in social investing. Over the past year, investors and governments across the country have committed millions of dollars to exciting new tools like social impact bonds (SIBs), which deliver a financial return only when specific social goals are met.[1] But this approach is not new. Indeed, socially driven investors have used the PFS model for more than a quarter century.

Consider the Low Income Housing Tax Credit (LIHTC), the primary tool for financing affordable housing development in the United States since the mid-1980s. Under this program–which deployed more than $8 billion in private capital last year alone–private investors front the money for a developer to construct rental housing that is affordable to low-income families, defined as those making less than 60 percent of the area's median household income. In exchange, the investor is given a tax credit from the federal government, redeemable only when construction is completed and the low-income family moves into their new home. The rent must stay affordable for a 15-year window, throughout which the government can recapture the tax credit in the event of noncompliance.

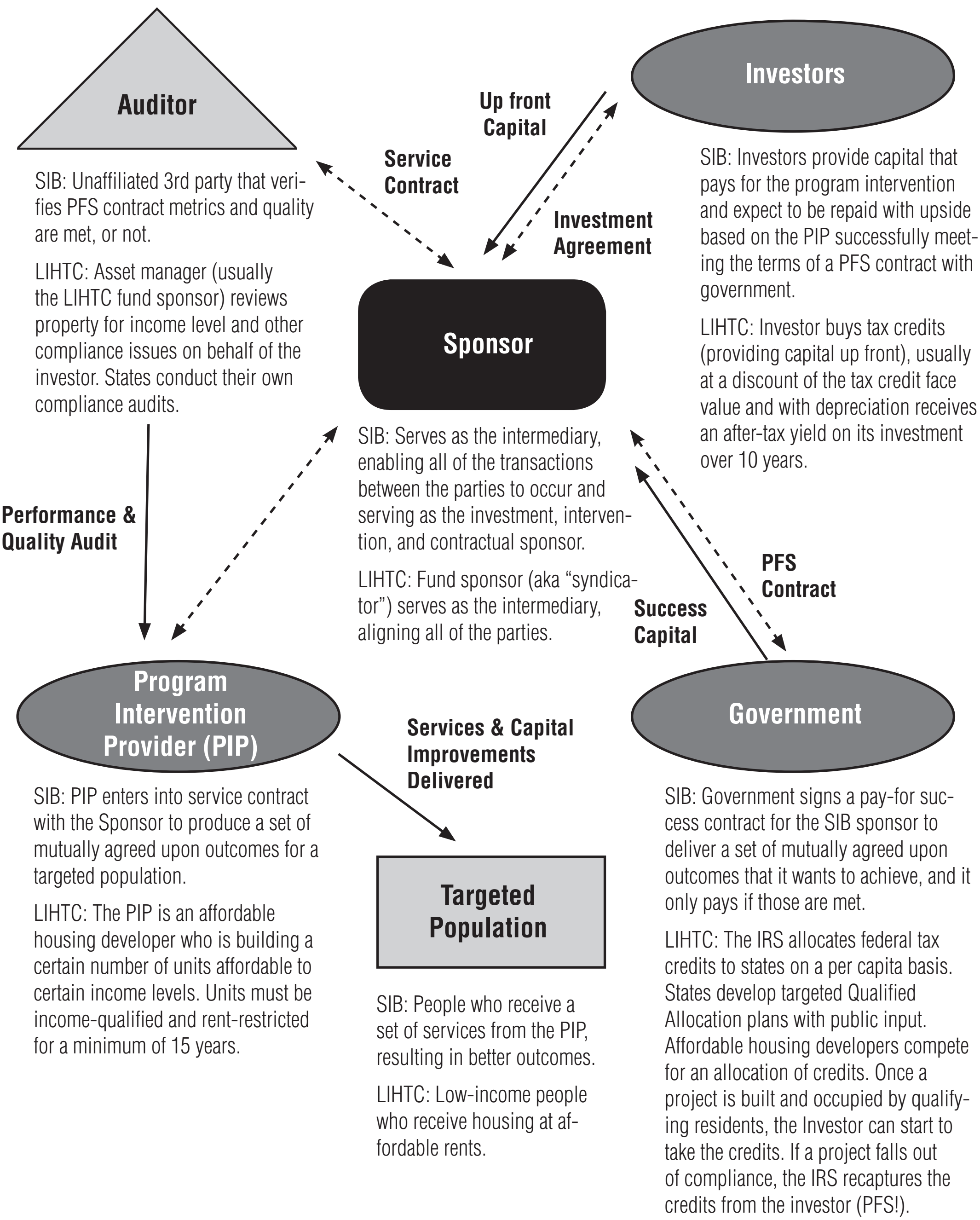
In other words, the federal government only pays if the program is successful–in this case if an affordable home is actually built and inhabited by a low-income family at affordable rents for at least 15 years.[2] If that goal is not met, private investors, not taxpayers, are on the hook.

Sound familiar? In a basic SIB agreement, a private investor provides initial capital for a social program, say one that serves the chronically homeless. With the help of an intermediary, all stakeholders agree to a set of measurable performance goals, say cutting the number of chronically homeless by half in a certain number of years. A government entity then agrees to pay the full cost of the program plus a premium to the investor, but only if that goal is met. If the program falls short, the private investor loses money.

1 For more information on SIB deals today, see Kristina Costa and Jitinder Kohli, "New York City and Massachusetts to Launch the First Social Impact Bond Programs in the United States" (Washington, DC: Center for American Progress, November 2012), available at www.americanprogress.org/issues/economy/news/2012/11/05/43834/new-york-city-and-massachusetts-to-launch-the-first-social-impact-bond-programs-in-the-united-states.

2 In reality, units funded through the LIHTC are required to be rented at affordable rates for a 30-year period. After the 15-year recapture period, there is an additional 15-year covenant on the land that requires that the rent stay affordable. However, the federal government can only recapture tax credits over the initial 15-year period.

Figure 1. How SIBs and LIHTCs are Similar PFS Models



Of course, these are both oversimplified summaries, and the details vary greatly from deal to deal. Still, one thing is clear: as we seek to ramp up SIBs and other PFS tools in the coming years, we need not start from scratch–we have more than 25 years of LIHTC experience to draw on.

This article lays out the lessons investors, governments, and service providers can learn from tried-and-true PFS models, with a particular focus on the LIHTC. It also presents a recent example of how Enterprise Community Partners is working to tackle a pressing social problem–the intersection of rising health care costs and senior housing–by employing new PFS tools.

Lessons Learned from the Low Income Housing Tax Credit

The LIHTC was created in 1986 as an efficient and resilient public subsidy for affordable housing development. Instead of simply writing a check and hoping for the best, Congress devised a way to share risks with private investors and tie subsidy payments to the actual production and maintenance of affordable rental homes.

Since 1986, a sophisticated market has evolved around the LIHTC, composed of developers (in PFS terms the "service providers"), governments (the "payers"), investors, auditors, and intermediaries (also known as "syndicators"). We've learned from this experience that certain ingredients are essential to a successful PFS agreement:

A strong and proven service provider. Achieving real-world impact is central to any PFS agreement, and that starts with the individuals on the ground who are working for social change. The provider must be committed to the end goal and have a well-documented record of successful outcomes.

A motivated government entity. The government partner must be able to sign a long-term contract without extensive legislative or bureaucratic delay. It must also be trusted to make good on its financial obligations and ensure that reliable data are collected and shared within a reasonable timeframe.

Flexible and socially driven investors. Most PFS deals will not compare directly with more traditional financial products. Sometimes the risks will far outweigh the potential returns, other times those risks will be difficult even to quantify. That requires a special brand of investor who is mutually interested in social and financial benefits.

A trusted intermediary. Although the model seems simple, these deals are often very complicated. An intermediary is crucial to manage relationships, handle financial transactions, and collect and verify performance data. With so many players, each with his or her own motivations and priorities, it is important to have an experienced coordinator who has some skin in the game, even if it is just reputational risk.

Toward a More Collaborative, Performance-Based Approach to Financing

Despite the successes of the LIHTC over the past two decades–2.5 million affordable homes developed,[3] nearly $100 billion in private investment leveraged,[4] hundreds of thousands of jobs created[5]–the program is far from perfect. For example, money from the tax credit can only be used for capital investments, meaning resident services require alternative funding sources.

One challenge before policymakers today is to develop similar PFS models that link housing production with related services, such as health care, child care, and transportation. Often these programs work toward common goals–such as building healthy, thriving communities–but are isolated by program-specific funding streams and other restrictions.

At Enterprise, we are developing new ways to build on our 30 years of experience to help fill this financing gap. Our solution: move away from today's siloed, appropriations-based approach to funding social programs and toward a more collaborative, performance-based approach that engages the private sector.

Of course, that's much easier said than done. Here's one example of putting that model into practice today.

A Case Study in PFS: Senior Housing and Health Care in Vermont

For more than 30 years, the mission-driven Cathedral Square Corporation has provided high-quality affordable homes to 2,000 low-income seniors in Vermont. The organization relies on a variety of subsidy programs, including LIHTC, with Enterprise Community Partners often assisting as an intermediary.

Over the years, Cathedral Square has come to understand the day-to-day needs of its residents and has uncovered gaps in their services. Recently, they realized a pressing need for coordinated medical and wellness services. In one instance, a resident was discharged from the hospital late on Friday night, but returned home to discover that all transitional support was unavailable for the entire weekend. In another, a resident's medical information was inadvertently switched with a different patient's, leading to a medication overdose. Without a medical advocate on hand, the patient was diagnosed with dementia rather than attributing the problem to a clerical error.

None of these were "housing problems" per se, but they certainly affected the lives of Cathedral Square's residents. Something had to be done.

Using funding from Vermont's Medicare reform pilot, Cathedral Square established the

3 In 2010, Low Income Housing Tax credits financed 50 percent of all multifamily housing starts, according to the National Association of Home Builders.

4 The LIHTC program leveraged $75 billion in private investment between 1987 and 2008, according to Ernst & Young. Since then, an additional $7-8 billion has been leveraged each year. For more information, see http://www.enterprisecommunity.com/low-income-housing-tax-credits-policy.

5 According to the National Association of Home Builders, the LIHTC program supports the creation of roughly 95,000 jobs each year. For more information, see http://www.nahb.org/fileUpload_details.aspx?contentID=151606.

Support and Services at Home program, which provides a nurse and care coordinator for each group of 100 seniors. In its first year alone, the program saved Medicare 30 percent in health care costs, mostly through improved monitoring, better coordination of services, and more at-home care.

Soon after, Cathedral Square realized that the physical layout and condition of their units and common areas were contributing to additional health problems, resulting largely from trips and falls. Small capital investments could generate further savings, as well as better outcomes for residents. Such capital investments, however, could not be made with Medicare funds. Cathedral Square needed a new source of capital that focused on real-world outcomes–such as improved health and lowered health care costs–rather than narrow funding streams. That's where Enterprise stepped in to help.

Working with Cathedral Square and other stakeholders, Enterprise is developing a new PFS product called the Socially Aligned Value Investment, or SAVI. The SAVI is structured more like equity than a bond, but it is rather consistent with the SIB model. Here's how it works:

- The Vermont government or possibly an Accountable Care Organization–whichever has exposure to the health care costs of this population and is interested in reducing cost–acts as the "payer" and sets measurable goals for improved health outcomes and reduced costs. If those goals are met, the payer agrees to cover all associated costs plus a premium.
- Private investors provide upfront capital for the necessary services and capital improvements. If the goals are met over a defined period of time, they are repaid plus a premium. If not, they lose this initial investment.
- Cathedral Square provides the necessary services and capital improvements, with meaningful discretion over how the money is spent.
- Enterprise serves as the sponsor or intermediary of the transaction, coordinating and implementing all of the contractual relationships among investors, Cathedral Square, and the payer.

As we work to integrate these services into an outcome-based model, all stakeholders will need to be flexible. Cathedral Square will need to meet reporting and risk criteria for investors and the payer. The payer will need to set reasonable metrics of success that are both ambitious and achievable. The investor will need to accommodate a return that may not be comparable to more mature investments where risk can be better quantified. Enterprise will need to find ways to independently verify progress and settle disputes if they arise.

If all goes well in the end, Cathedral Square will finally receive the funds and flexibility they need to discover new ways to improve services and lower costs. The payer can test innovative cost-cutting solutions without spending a dime if they fail. Private investors carry the most risk, but they are given a rare opportunity to pursue meaningful social change alongside financial returns.

Next Steps

In an era of fiscal austerity, it is more important than ever to maximize the real-world impact of every available dollar, whether it comes from the government, a philanthropist, or a for-profit investor. That is the primary goal of the PFS model.

Our team at Enterprise is exploring new ways to use PFS to solve our most pressing social problems. As our work in Vermont and throughout the country takes off, we will diligently monitor our progress and expand on what works, both in the solutions we pilot and the financing tools we use to fund them.

Terri Ludwig is president and chief executive officer of Enterprise Community Partners, Inc., a national nonprofit provider of development capital and expertise to create affordable homes and rebuild communities. Prior to joining Enterprise, Ms. Ludwig served as president of the Merrill Lynch Community Development Company and president and CEO of ACCION New York, the largest nonprofit microlender in the United States. Ms. Ludwig has 23 years of experience in investment banking and nonprofit leadership, was a presidential appointee to the US Department of the Treasury Advisory Board for Community Development and Financial Institutions, and was recently named to Forbes Magazine's *first-ever "Impact 30," a roster of 30 of the world's leading social entrepreneurs.*