Human Capital Performance Bonds

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The concept of the "new normal" has infiltrated the thinking of policymakers, employers, and service providers. Brought about by demographic and technological changes, the new normal demands change: business as usual will no longer work.

For human service providers, the new normal poses some big challenges. Faced with tighter budgets, federal, state, and local governments are cutting back on discretionary programs, often human services. Ironically, these same human services, funded appropriately, could help remedy public budget imbalances over the long run because they deliver preventive measures and social change. Numerous studies have shown that the best human services programs deliver more in benefits than they cost: for example, early childhood learning, workforce training, post-incarceration programs, chemical dependency treatment, supportive housing, and counseling for long-term caregivers.

Social impact investing provides an answer to the question: How can we identify and fund those human services that improve the health of our communities over the long run and pay for themselves? Like traditional investing, it recognizes that certain social interventions provide financial gains to investors. Unlike traditional investing, it also provides improved social and financial outcomes to clients and taxpayers.

So far, activity is limited to a few places, and each place is moving forward with its own version of social impact investing. Great Britain launched its effort in 2010 with investments in its Peterborough prison. New York City recently began a pilot in its Rikers Island prison. Both Massachusetts and Minnesota have passed legislation for pilot projects, although implementation has yet to commence. Others, from Connecticut, Ohio, and California in the US to Australia, Germany, and the UK are developing other pilots.

There are a variety of models of social impact investing, including variations on the social impact bond (SIB) and the human capital performance (HUCAP) bond. The HUCAP bond has two key design features that distinguish it from SIBs: (1) payment to social enterprises is based on their performance, and (2) it uses bond funds for capital.

In 2011, the Minnesota legislature passed the "Pay for Performance Act," which authorized the sale of $10 million in annual appropriation bonds to finance a HUCAP pilot project. HUCAP bonds are based on the premise that many social enterprises create financial value from the social benefit they create. This financial value can be measured, captured, and used as a source to attract market-rate investors such as pension funds, 401k plans, and insurance companies to buy bonds.

Origins of the HUCAP Bond

The Minnesota HUCAP bond model is based on experience from a 15-year Pay for Success (PFS) contract between the Minnesota Department of Employment and Economic Development (DEED) and Twin Cities RISE! (TCR!), a workforce development nonprofit that provides intensive education and training services to difficult-to-employ individuals. TCR! is paid only when a client is placed in a job earning more than $20,000 per year and where the change in their income is at least $10,000. The amount of TCR!'s payment is directly related to the economic value that the change in income created from higher income and sales taxes and lower public costs for low-income health care, child care, subsidized housing, and incarceration costs. TCR! is paid half at placement and half after one year of retention on the job. Over the last 15 years the state has enjoyed a return on investment (ROI) of more than 600 percent.

This long-term arrangement suggests that social outcomes can be defined, economic data can be measured, and providers can be rewarded on the basis of the financial value they create for the state from their successful interventions. It also suggests that high-performing social enterprises would benefit from this PFS arrangement.

HUCAP Bond: Starting with Performance

With the HUCAP bond, the government enters into contracts with service providers. The payment is not a fixed amount, but varies with the performance of the provider. The more financial value human service providers create, the more they are paid. Meanwhile, the state sells conventional bonds to create a pool of cash for paying the human service providers when they perform. As the state begins to reap the financial benefits, it sets these aside to pay interest, amortize the principal, and cover administrative costs (totaling approximately 13 percent per year for a 10 year bond).

Because service providers get paid only if, and not until, outcomes are substantiated, a separate working capital fund will be established from which they can borrow.

Paying providers for the value they create encourages them to continually improve performance. The mere creation of a tool to measure ROI has workforce training providers asking, "What's my ROI?" Ideally, best practices will become known and disseminated to help all providers improve their ability to serve their clients.

Moreover, the common problem of "cherry-picking" (choosing to serve only the easiest cases because the payment doesn't vary) is diminished. Because providers are paid for their value-added, they will be compensated more for good results with harder to serve clients. In workforce training, for example, the outcomes are more dramatic for clients who have been out of the workforce longer, or incarcerated, or heavily reliant on public benefits.

Infusion of Capital into Human Services

The HUCAP structure is designed with state bonds[1] for one primary reason–to facilitate the largest pool of capital investment, which is market-rate bond investors. By using a government bond, investors do not have to conduct due diligence about the service providers, or indeed, have any concern about their performance; it is the government's credit rating they care about. The use of state bonding takes advantage of existing structures for rating agencies, underwriters, and bond sales. This enables the HUCAP bond to minimize transaction costs, keep the cost of capital low, and scale-up to levels of investment commensurate with the opportunities identified. There are $3.7 trillion of municipal bonds outstanding in the US

Major Shift in Budgeting Practices

The HUCAP bond also creates a major shift in the way governments budget. Using bonds to finance human services is an implicit recognition by the state that benefits often accrue over a number of years. For example, we don't educate five-year-olds because we hope they'll be contributing members of society by the time they are seven. Government currently tends to underinvest in social services, because budgeting rules only recognize short payback periods. A 10-year bond enables human services to invest for the highest long-term social and financial return.

Budgeting also tends to take place in silos–that is, government budgeting is usually done at the agency level, without taking into account the costs or benefits from their activities that accrue to other departments. As the workforce training example suggests, costs and benefits can be spread over many agencies. With conventional budgeting, Minnesota's DEED pays for the services. But the Departments of Human Services and Corrections see reductions in their spending as a result, and the government's coffers grow from increased tax revenue. The HUCAP bond provides a way of accounting for all of these costs and benefits by accumulating all new revenue and cost savings across government agencies. The HUCAP bond will help public agencies see and act on the bigger picture impact of human services.

Third, the focus shifts from activity to outcomes. How can we identify and fund those human services that contribute to the health of our communities over the long run? Government budgets are notorious for funding activities (such as seat time for school children) rather than meaningful outcomes (such as how much did they learn or did they graduate). Part of the problem is that defining and measuring outcomes can be very difficult. It's no easy task, but it can be done, and part of the HUCAP bond pilot program will be developing and testing such a measurement system for a variety of areas.

Finally, the focus shifts from cost to value. There is a tendency to underinvest in more

1 It is also possible for another entity such as a financial institution, consortium of nonprofits, or housing authority to issue bonds provided there is an iron clad contract with the relevant government to "pay for success" based on the economic value created. Ultimately we believe the market will evolve in this way as the risk and return of the HUCAP bond becomes established. While more expensive to issue, this evolution will potentially enable more HUCAP bonds as states and counties usually have limits on the amount of bonding that they can issue.

intensive services because they are more costly. Such budgetary decisions ignore the other side of the equation–what benefits are being created? Analyses of workforce training programs in Minnesota, for example, showed that programs offering more intensive services tended to produce superior outcomes. By measuring ROI instead of cost, the focus shifts to providing services with the highest returns to the individual, society, and taxpayers.

Questions About the HUCAP Bond

There are three common concerns about the use of bonding for social services:

1. ***The service provider takes too much risk.*** While it is true that the service provider takes most of the risk in this approach, much of it is reduced in practice. Only high-performing human services whose interventions create economic value above the government's cost of paying its debt obligation will be interested or invited to participate. (Other providers will be incented to improve their outcomes so that they can participate.) And during the pilot period, half of the working capital provided to participating nonprofits is expected to be nonrecourse debt.
2. ***The cost of borrowing working capital is too high.*** Working capital loan rates can be kept low by seeking funds from foundations' equity, program-related investments (PRIs), and banks' Community Reinvestment Act funds. The working capital is also leveraged by the eventual performance payments. For example, for $10 million in bonds, $3 million of working capital is expected to be required. If interest rates were as high as 6 percent on the amount borrowed, the effective interest rate on loans to the providers would be one-third of that, or 2 percent.
3. ***Many states or countries already have too much debt.*** The HUCAP bond is a bond that pays for itself. Bond funds are only expended by government in an amount no greater than the financial benefit the government receives. If service providers fail to perform, the bond could be called, with little interest cost expended.

The Similarities and Difference Between HUCAP Bonds and SIBs

Both SIBs and HUCAP bonds are intended to provide incremental investment in high-performing social enterprises. They both make payments based on the economic value that the social interventions create. They also share the need for accurate and transparent measurement.

They differ in the structure of the investment. Although they're called bonds, SIBs are not actually a bond or a debt instrument. Rather, they are more like a social venture capital investment or a form of equity. HUCAP bonds are government issued bonds just like those issued for infrastructure. And although both use PFS approaches based on the economic value being created, they apply it differently. In SIBs, all the risk and incremental reward accrues to the investor. With the HUCAP bond, the risk is primarily borne by the service provider, but this is its opportunity to earn higher payouts for better performance. This enables the

HUCAP bond's cost of capital to remain low, equivalent to the government's bond rating (at 3 percent for a taxable AA bond today) versus rates up five times higher for the SIB. To date, SIBs have either attracted social investors (wealthy individuals and foundations) or required a foundation guarantee (the NYC model), whereas HUCAP bonds are targeted to market-rate investors, a much larger pool of available capital. The HUCAP bond approach, if successful, can scale up quickly across the country, and indeed in other countries, to potentially billions of dollars given the size of the bond market globally.

The Status of the HUCAP Bond

Legislation to create a HUCAP bond pilot was passed in Minnesota in 2011. It authorized $10 million in annual appropriation bonds for the pilot project. An oversight committee was established to oversee the work of Minnesota Management and Budget, the state agency responsible for issuing the bonds. Invest in Outcomes, the Minnesota nonprofit that developed the HUCAP bond model, provided economic analysis in five areas of potential piloting. The state chose to pilot in workforce development and supportive housing.

The issuance of the bond was held up for more than a year by a legal case against another appropriation bond. The Supreme Court of Minnesota provided a positive ruling in November 2012 enabling the issuance of HUCAP bonds to go forward. Bonds are expected to be issued in 2013.

What's Needed to Move Forward

The development of HUCAP bonds and SIBS could be accelerated by specific actions on the part of players in the social enterprise, government, and investment sectors.

Social enterprises, especially nonprofits, must begin identifying their social outcomes–that is, the long-term benefit of their interventions, not just the outputs that are the standard fare today. They further must start identifying and measuring these outcomes and also work with economists as they develop ROI calculations necessary for a social impact investment.

Governments must think and act more as investors rather than mere spenders of tax dollars. They must refine their measurement and accounting systems to track and capture the value of preventive interventions. They also must be open to rewarding providers and/or investors for the value that their actions created.

The federal government should use its existing waiver authority to share the financial benefits it receives as a result of the actions of states and municipalities that implement these investment vehicles. In some programs, such as Medicaid, the federal government garners at least half the savings created by state and municipal interventions because it pays at least half the cost. It should share part of its benefit to incentivize additional local investments.

The existing infrastructure of banks and consultants can play an important role in spreading and refining these models. Banks can provide capital, advise governments on the opportunities, and underwrite bonds. Consulting networks can help providers and government learn how to establish and implement these investment opportunities.

There is confusion about the term SIB, or social impact bond, given that it really is not a bond. The HUCAP structure offers an alternative that is a bond. It would be helpful if there were agreement about what the field should be called (social impact investing perhaps) and clarity about the various alternative models. The current situation is not helpful to providers, governments, or investors who are trying to understand this new area of social investing.

Social impact investing is in a nascent stage. It has the potential to provide significant levels of new capital to help solve a wide array of social issues. Yet it is so new that it will be important to pay careful attention–no matter what the model–to "design" failures and successes and distinguish them from "execution" failures and successes. Have we accurately measured financial value? Is the model workable from all points of view–service providers, government, and investors? How can we improve the model? Can this idea be brought to scale?

As the actual risk and return is better understood through implementation of additional pilots new investment vehicles that attract additional investors interested in different combinations of risk and reward will emerge. The HUCAP bond will be one of an array of investment vehicles that can finance important social enterprises, just like in the commercial world.

Steve Rothschild is the president of Invest in Outcomes, the nonprofit he founded to develop the human capital performance bond. He is also the founder and chair of TwinCities Rise!, an award winning anti-poverty, workforce nonprofit. Previously he was executive vice president of General Mills where he launched its Yoplait Yogurt subsidiary. He is the author of The Non Nonprofit: For-Profit Thinking for Nonprofit Success.