

# Innovation Needs Foundation Support: The Case of Social Impact Bonds

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For more than 100 years, philanthropy has taken risks other sectors either would not or could not take to advance innovations benefiting poor or vulnerable people. The Robert Wood Johnson Foundation hatched the idea for a national 911 emergency response system. The Ford Foundation promoted the concept of community development corporations that would create jobs, preserve affordable housing, and promote small businesses. The Carnegie Foundation supported the initial development of Pell Grants. The Rockefeller Foundation funded the research behind the ideas that evolved into the US Social Security system.

Foundations are in the unique position to take risks, connect people and organizations with diverse perspectives, and cultivate groundbreaking innovations. And philanthropy is perhaps most useful when it can galvanize and leverage the actions and resources of others to build and sustain ideas that were once considered risky but have proven effective in meeting a pressing societal need.

As society's provider of risk capital, philanthropy has traditionally supported promising new approaches, established the viability of new models, and then handed off those that prove effective and efficient to governments for scaling up. For many reasons—information asymmetries, political entrenchment, and legacy contracts, among others—this process is no longer always operational. Philanthropy is now required to fund innovations into and through a path to a larger scale.

Yet improving social and environmental conditions will require more capital than public dollars, philanthropy, and civil society contributions can provide. With the emergence of the field of impact investing, the marketplace now has viable opportunities to join government and philanthropy to finance capital-intensive social initiatives.

But philanthropy, as noted frequently and most recently in the ImpactAssets issue brief “From Grants to Groundbreaking: Unlocking Impact Investments,”<sup>1</sup> still plays a catalytic role in leveraging these arrangements. Social impact bonds (SIBs) in the United States offer several different opportunities for philanthropy to strategically provide risk capital along the innovation curve, from seed funding to catalyzing capital market evolutions. As interest in the SIB instrument grows, philanthropists may consider the different ways of applying, sequencing, and layering philanthropic dollars, as explored below.

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1 Amy Chung and Jed Emerson, “From Grants to Groundbreaking: Unlocking Impact Investments,” ImpactAssets Issue Brief 10, available at [www.impactassets.org/files/Issue%20Brief%20%2310.pdf](http://www.impactassets.org/files/Issue%20Brief%20%2310.pdf).

## Motivation

SIB investors are motivated by different drives. In the first SIB pilot in Peterborough, United Kingdom, the investor group was motivated almost entirely by philanthropic interests. Some were focused on the potential of SIBs to address a problem domain—criminal justice—in which they were deeply engaged. Others were interested in the SIB because of the opportunity it posed as an instrument with potential applications across a range of domains from early childhood education to in-home care for older people.

Since then, many philanthropists and foundations have been influenced by both motivations. In the New York City pilot, well described elsewhere in this journal, Bloomberg Philanthropies was motivated by the application of SIBs to achieve greater outcomes for young men of color. Equally, Bloomberg Philanthropies saw the opportunity, once the hard work of developing the SIB structure and executing the contracts was completed, for the next wave of SIBs to be applied to other priority areas in the city.

Regardless of the motivation, direct investments into SIB pilots are not the only type of risk capital that philanthropies have contributed toward realizing the promise of SIBs. Indeed, foundations provided the grease that got the whole system moving in this direction.

## Field and Capacity Building

In 2010, the risk of early failures threatened the long-term potential of SIBs, nearly stunting or killing the innovation altogether before early-adopter nonprofits and localities had the opportunity to test its value.

Specific concerns were the following:

- Political pressure and organizational imperatives could lead to the launch of bonds that were poorly targeted and/or poorly structured. Failure of these early experiments could ultimately create “false negatives” about the innovation itself.
- The “first-to-market” rush of private, interested actors to capitalize on the momentum of the bonds could result in the launch of instruments that meet only the lowest-common-denominator standard. This rush could result in a missed opportunity for robust impact evaluation and data creation. Data capture and the establishment of a measurable track record could have the additional advantage of assisting in the further development of policy in the areas of intervention.
- Though private foundations’ program-related investment (PRI) money was an attractive option to capitalize the first bonds, the terms and structures of PRI-capitalized bonds could “lock out” the private capital markets that constitute the ultimate opportunity to apply the concept on a larger scale.

To ensure appropriate testing of this unproven instrument, philanthropy, including the Rockefeller Foundation, focused on field and capacity building to ensure: 1) the quality of the first social impact bond deals, and 2) the engagement of capital markets and the catalytic role of PRI investments. For the Rockefeller Foundation, this strategy included:

- Support for knowledge creation and broad education leading toward market transparency;
- Support for the first-mover mayors' and governors' offices to increase their capacities to negotiate, structure, and execute bonds;
- Provision of planning grants to a small, select group of intermediaries and service providers;
- Research on the future of SIBs—political trajectories, investor landscape, and possible adaptations to environmental or international development contexts; and
- Demonstration of the highest-leverage role for foundation investment capital in SIBs.

Through the diligent and hard work of the pioneering stakeholders in the SIB space, the United States is on its way to testing several SIBs across the country. But despite this early progress, the field is still in its nascent stages. Different sets of stakeholders still need room to think, plan, exchange ideas, and build upon the SIB instrument.

Foundations can help make this room by providing grant support to ensure robust capacity in government budget offices and agencies, nonprofit service providers, intermediaries, and evaluators to explore and gear up for SIB or SIB-like financing instruments. A secondary, but still vital, set of actors would benefit from support: policy analysts, think tanks, and the media play a key role in ensuring that the SIB instrument can be appropriately tested.

Philanthropy can also help build the capacity to look across deals, discern patterns, and generate knowledge about the impact of SIBs on all actor groups as well as on the beneficiaries of SIB-funded services.

## Leverage

Philanthropies also have the flexibility to collaborate with investors, either directly or indirectly, to catalyze larger and newer flows of capital to meet pressing social needs. This role is nothing new—the sequencing and layering of capital for social good has been well described and executed. In the realm of affordable housing, for example, the Ford, MacArthur, and Rockefeller Foundations, among other public and private entities, helped create the New York City Acquisition Fund with the first-tier capital of \$50 million, which allowed commercial lenders such as JP Morgan to provide \$250 million of debt financing.

For SIBs, a sequence, albeit a stretched-out one, could start with grants to help key actor groups to bring their best capacity toward SIB deals. As those deals materialize, philanthropy can increasingly focus on creating credit enhancements for specific SIB deals. Concessionary capital such as recoverable grants, forgivable loans, and other below-market-rate PRIs can provide a subordinated or first loss layer of capital to reduce risk for, and leverage additional capital from, more commercial impact investors. The Godeke Consulting report “The

Investor Landscape” describes this territory in depth.<sup>2</sup>

As of this writing, several funds are being established for use by intermediaries as first-loss investments or as reserves for SIB deals. The idea of a foundation investment circle or syndicate is also being pursued. These funder collaborations are not only important for the efficiency generated in the capital market for SIB deals; they also create a singular constituency for the government to answer to, enabling public servants to take what might be real political risk in engaging in a SIB deal.

This creativity is only a hint of changes likely to come. A secondary market could develop, with initial investors in a SIB selling their stake to others who want to see some indication of performance or an early track record before investing. Another likely evolution is the use of the SIB instrument to fund innovation. At present, SIB deals ask investors to take a big risk on the SIB model itself. Pilot projects reduce execution risk by backing “proven” interventions with a strong evidence base of efficacy. But on the horizon are deals, not necessarily involving government payment, that employ a SIB to fund both model and execution risk—providing proof of concept of promising but not proven interventions. Here, philanthropy can act as payers or copayers with other private entities for outcomes on the issues that are toughest to measure or where cost savings are not accrued by achievement of social good.

To be sure, SIBs are only the tip of a spear. The changed relationships, knowledge creation, capacity, and track record of SIBs will no doubt bring future innovative financing vehicles into view more quickly and easily than before. For this reason, the Rockefeller Foundation has dedicated itself to building the ecosystem and field for SIBs—which are important in their own right but even more powerful as the precursor of innovations yet to come.

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2 Steven Godeke and Lyel Resner, “Building a Healthy and Sustainable Social Impact Bond Market: The Investor Landscape” (New York: Godeke Consulting, 2012), available at [www.rockefellerfoundation.org/news/publications/building-healthy-sustainable-social](http://www.rockefellerfoundation.org/news/publications/building-healthy-sustainable-social).