Pay for Success: Understanding the Risk Trade-Offs

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Pay for Success (PFS) financing is a relatively new concept in the United States, with great potential for improving the social sector and government efficiency. As with anything new and disruptive, there are numerous unknowns for the pioneers forging the early path. Early excitement about the first social impact bond in the United Kingdom (Peterborough prison pilot) was quickly followed by the question, How will this work in the United States, and what are the risks? When new financial markets emerge, it is common to see wide variation in the proposed mechanisms for addressing risk, reflecting the different perspectives and risk tolerances of the participants involved. Only by understanding, quantifying, and managing this risk will investors become comfortable enough to invest in PFS financing structures.

Over the past two years, Nonprofit Finance Fund has served as an independent voice in the emerging PFS financing market.[1] As we have engaged stakeholders on the value of the model, we have been persistently asked about risk trade-offs. How can we consider risk sharing to enhance market participation? How can structures be adapted to respond to local market context? What might the PFS financing market look like in the future? And what risk preferences would have to be considered and balanced in order get there? Answering these questions will be crucial to the development of a mature and robust PFS financing market in the United States.

Risk Considerations for Partners Involved

The first step to creating a PFS financing structure is to understand the risk trade-offs that underpin it. In particular:

- The potential for measurable social impact
- The ease of identifying and capturing the economic value of social impact
- Financial risk and return to each stakeholder
- Reputational risk for each stakeholder
- Transaction execution and due diligence costs
- Cost of capital to the government funder and service provider(s)
- Transaction management and governance structures
- Legislative requirements and appropriations risk

1 Our work includes curating www.payforsuccess.org, a neutral platform that provides education and disseminates information on the potential benefits and challenges of PFS financing. This perspective has given us the privilege (and obligation) of both heralding the development of the PFS model and calling out the gaps in its development.

- Changes in procurement and contracting systems
- The potential for replication and scaling

PFS financing projects require significant collaboration on all of these issues from three key stakeholders–government, investors, and service providers.

Government

In a time of shrinking budgets and a simultaneous call for both cost reduction and innovation, the PFS model provides governments that have the political will the opportunity to test a hypothesis that requires a "new way of doing business" in the provision of services.

Governments taking the lead on PFS financing face reputational risk tied to both providing services and testing a new approach. There are also risks associated with introducing new policies and practices to accommodate PFS financing. Balancing these risks is the prospect of accessing private capital at no cost to the government until outcomes are achieved.

Given the decentralized governmental structure in the United States and the continued pressure at the state and local levels to manage shrinking revenues while maintaining services, it is most likely that cities, counties, and states, rather than the federal government, will launch proof-of-concept pilots of PFS financing in the United States. The federal government has advocated this bottom-up approach and now provides a variety of resources to facilitate the development and launch of proof-of-concept pilots by cities, counties, and states. The Department of Labor has committed $20 million through the Workforce Innovation Fund to PFS financing projects that help Americans find work, and the Department of Justice, under the Second Chance Act, made grants that gave preference to applicants who incorporated a PFS financing element into recidivism reduction/job creation programs. These two solicitations will likely incentivize greater piloting of PFS financing models and may pave the way for increased activity at the federal level.

Investors

Much of the appeal of PFS is the prospect of attracting new money to social problem solving. There is a healthy appetite for investment opportunities that deliver social as well as financial value, though the recent recession has made some investors less likely to experiment with new vehicles. The cliff-like risk structure piloted in the Peterborough social impact bond, where investors provide all the needed capital upfront and risk losing 100 percent of their investment capital if the outcomes are not met, offers one alternative for risk allocation in PFS financing. Openness to and support of hybrid and alternative transaction execution structures will provide more diverse ways of allocating and apportioning risks, returns, and other material trade-offs to private investors. The structure recently unveiled by New York City and Goldman Sachs, with commercial investors benefiting from a partial (75 percent) guarantee from a philanthropic investor, exemplifies a shared-risk structure. Having this structure in the market is expected to accelerate the development of other structures that appeal to a broader pool of potential investors and increase the magnitude and pace of private, commercial, and impact investing capital flows into the US social sector. For example, serious consideration is already being given to lower guarantee levels and the use of subordinated debt.

Service Providers

At the core of the PFS financing structure is the delivery and measurement of positive outcomes for individuals, families, and communities of need and delivering these outcomes at scale. Thus, the success of PFS financing is ultimately dependent on the performance of service providers. However, the number of PFS financing–ready providers in the United States is limited, in part due to the scale and size of many nonprofit providers and the long-standing revenue model that rewards simple outputs and is driven by cost reimbursement–a business model that is not well suited for participation in outcome-driven PFS financing. As a result, providers entering into PFS projects who are not prepared to operate programs under an outcomes-based contract are at risk of underperforming, failing to meet contract terms, and not completing the contract work. Thus there is real risk of an unprepared provider compromising the organization's reputation for providing good results to people in need. Additionally, depending on whether the working capital delivered to providers in PFS financing is available up front or upon meeting contract terms, the provider may bear significant operating and financial risk while undergoing significant change and building its capacity. Incubation and acceleration of provider PFS financing readiness is needed to build a pipeline sufficient for the replication and growth to the scale necessary to build a sustainable PFS financing market in the United States. Provider readiness is one of the best and most sustainable risk-mitigation vehicles because it goes beyond an individual transaction to build the capacity of the field.

Among the small number of PFS financing–ready providers in the United States are established, high-performing local and multistate service providers that can act as program intermediaries in their social issue areas. By sharing their own experiences and providing template materials such as term sheets, these intermediaries can reduce the risk for other providers and help accelerate the development of a pipeline of providers ready for PFS financing. These organizations have the current capacity to act as first-mover providers and program intermediaries in proof-of-concept pilots of PFS financing. Tellingly, a program intermediary is present in the first two PFS projects in Massachusetts, as well as in the New York City social impact bond transaction.

PFS Financing: Transaction Characteristics and Types

In mapping the PFS financing market, we considered four probable structures:

Social impact bonds (SIBs): PFS financing is executed through the private equity structure utilized in the UK Peterborough transaction.

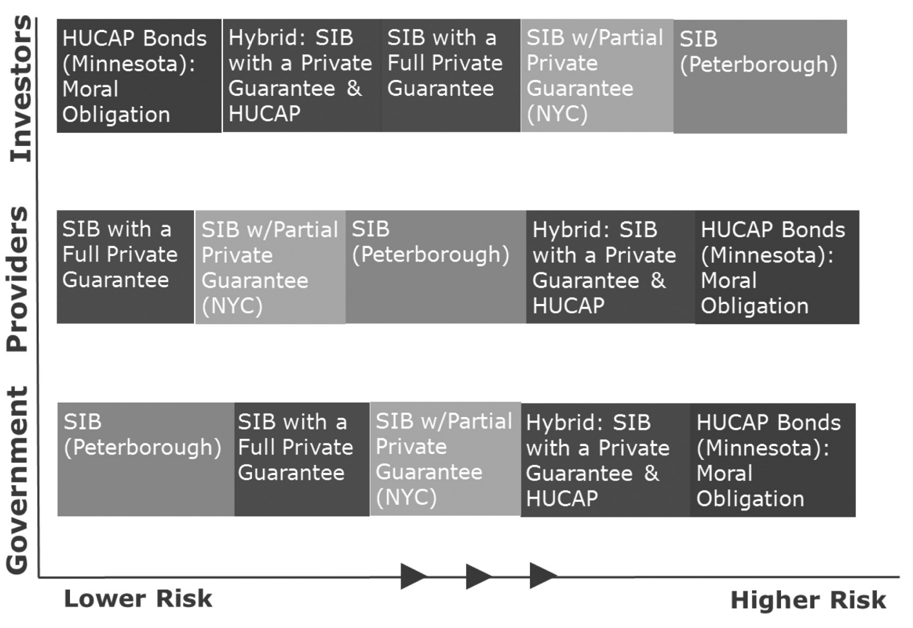
SIBs with a full or partial private guarantee: PFS financing is executed through the SIB structure with success payments to investors fully or partially guaranteed by a private (nongovernmental) enterprise. New York City is using the partial private guarantee structure in its PFS financing pilot.

Human capital performance (HUCAP) bonds: PFS financing is executed through state moral obligation bonds issued in the US municipal bond market–the structure Minnesota is planning to pilot under legislation recently passed in the state.

Hybrid: HUCAP bonds and SIBs with private guarantee: PFS financing is executed with a hybrid HUCAP/guaranteed SIB structure in which providers receive working capital up front from private investors at no cost via HUCAP bond proceeds. Providers shoulder all outcome performance risk but are backstopped by a private guarantee.

If we consider the risk continuum for each stakeholder individually, we can see (Figure 1) that investors, service providers, and government all have different risk preferences depending on the PFS financing structure. When we look at the three stakeholder perspectives combined, however, it suggests that some structures may be preferable to others. For example, a SIB with a full private guarantee might be the PFS financing structure most acceptable to all three stakeholders for a proof-of-concept pilot: it represents the lowest combined risk trade-off position for all three parties. In fact, the usefulness of a guarantee in aligning stakeholder interests in PFS financing pilots was affirmed as a "market-ready" approach in the announced New York City transaction with Goldman Sachs as investor and Bloomberg Philanthropies providing the partial guarantee. The market is also evolving toward lower partial guarantees and subordinated debt as a refinement to this approach.

Figure 1. Pay for Success Financing: Multiple Perspectives



Making Transactions Happen

PFS financing describes a broad category of innovative structures and approaches to financing social programs. Nevertheless, these approaches must have certain core elements in place to maintain the fidelity of the PFS financing approach:

- They finance prevention and early intervention services;
- They access private sources of working capital and/or risk capital to finance these preventative and early intervention services;
- They reduce both the cost and the risk of government funding for social programs;
- They direct private capital to social programs that "work" by achieving independently measured, positive outcomes for individuals, families, and communities of need; and
- They provide private investors with satisfactory and inextricably blended social and financial returns.

Each of these elements carries risk. Understanding how these risks affect PFS financing stakeholders is a critical step toward launching pilot transactions. This understanding will lead to greater openness to a diversity of structures and an increased interest on the part of various parties to participate in PFS financing. First-mover states and cities will likely attract the interest of commercial financial institutions, community development financial institutions (CDFIs), provider intermediaries, and impact investors, along with the needed public and political attention to bring more of this type of financing to the market.

Ultimately, changing the way we fund social services requires a balancing of shared risk and, hopefully, shared reward. Regardless of the success of each individual deal, the legacy of these early efforts will likely be new cross-sector partnerships, a move toward outcomes-based programs and financing, and a willingness to rethink the way we address critical issues in our communities.

Innovation and change do not come without risk. If we embrace the former, we must accept the latter. Our odds of success improve if we create the deal structures we need with an understanding of the motivations and expectations of all stakeholders.

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