Social Impact Bonds: Using Impact Investment to Expand Effective Social Programs

_Luther Ragin, Jr._*
Global Impact Investing Network

Tracy Palandjian
Social Finance, Inc.

To address the wide-ranging challenges facing the United States, collaboration among philanthropy, government, and the investment community is vital. Social impact bonds (SIBs) offer a new way to advance cross-sector partnerships and introduce innovative financing solutions to scale proven preventative social programs. SIBs operate at the intersection of three important trends: greater funder interest in evidence-based practices in social service delivery; government interest in performance-based contracting; and impact investor appetite for investment opportunities with both financial returns and social impact.

This article focuses on how impact investors in SIBs can help drive improved performance in the US social sector while providing growth capital to effective nonprofit or social enterprise social service providers. The true power of SIBs lies in the discipline that investors can bring to the process of provider selection and delivery of social services. When government, investor, and provider expectations are aligned, SIBs have the potential to bring significant new capital and efficiencies to social service delivery.

A New Vehicle for Impact Investors

Interest in impact investing has grown substantially in recent years. The Rockefeller Foundation and others effectively make the case that addressing complex societal problems requires larger scale funding and greater collaboration among philanthropists, government, and private investors. Although impact investment is only a small proportion of the total assets under professional management, it represents a significant and growing pool of capital that can fund programs to address social problems.

Impact investors have in common a desire to find projects that generate social impact and provide a financial return. The impact investment community is diverse and includes investors who seek to support a wide range of projects in both developed and emerging markets in areas such as affordable housing, accessible health care, financial services for the poor, and clean energy. Financial returns may range from below-market to risk-adjusted market rate, and investments may take the form of debt, equity, credit enhancement, or instruments that

* We would like to thank Min Pease, Global Impact Investing Network and Jill Scherer, Social Finance for their contributions to this article.

combine these elements. They may include program-related investments and mission-related investments, in which, unlike grants, foundations require a high level of confidence in the return of capital. In addition to foundations, diversified financial institutions, pension funds, high-net-worth individuals, and fund managers may make impact investments.

SIBs are a new investment vehicle designed to appeal to impact investors. Pioneered by Social Finance U.K. in 2010, this innovative financial instrument draws on private investment capital to fund prevention and early intervention programs that, if successful, reduce the need for expensive crisis-driven services. The SIB structure enables the government (or other payers) to shift program risk to private investors who finance the service delivery upfront, with ultimate payment to the investors based on the achievement of predefined outcomes. If the outcomes are not achieved, the government is not required to repay investors. In other words, the government only pays for results.

Although the terms are often confused, SIBs are a specific kind of Pay for Success (PFS) contract. PFS contracts are a contracting mechanism in which government (or another payer) pays service providers after they achieve predefined outcomes. Providers entering into these contracts have several options for financing program delivery: internal resources, loans from community development financial institutions (CDFIs) and banks, or grants or program-related investments from foundations. Most of these options impose significant financial risk on the provider. A SIB, by contrast, is a financing mechanism that shifts this risk to investors. By participating in a SIB, a provider working under a PFS contract can obtain operating funds to grow and scale without incurring additional financial risk. Given the scarcity of growth capital and the difficulty providers face in securing resources that enable them to serve a greater proportion of at-risk populations, SIBs can offer an appealing path to scale.

PFS contracts and SIBs share a premise of payment by results, but they differ in purpose. Beyond achieving results, SIBs explicitly seek to create a marketplace for impact investment, supported by rigorous due diligence and analytics. These market-building elements add costs for evaluation, legal, performance management, and other intermediation services necessary for driving social and financial outcomes. Because SIBs must bear these costs, their greatest potential lies where scale and improved performance are principal goals as well as social needs. Uniquely, the capital markets have the depth, flexibility, and rigor to support these aims.

To date, SIBs have mainly attracted grant funders and "impact-first" investors who are using their position in the market to test the model and provide proof-of-concept. To grow and achieve economies of scale, SIBs will need to be structured to also attract more commercially oriented "finance-first" investors.[1] US philanthropy–from individuals, foundations, and others–channels roughly $300 billion[2] to the social sector each year, but the capital markets are much larger, with US investments totaling more than $25 trillion.[3] By drawing

1 In its 2009 report, "Investing for Social & Environmental Impact: A Design for Catalyzing an Emerging Industry," the Monitor Institute defines "impact-first" investors as those who seek to optimize social or environmental impact with a floor for financial returns, and "financial-first" investors as those who seek to optimize financial returns with a floor for social or environmental impact.

2 Giving USA, http://www.givingusa.org.

3 The Forum for Sustainable and Responsible Investment, http://ussif.org.

on these investors, SIBs represent an opportunity to unlock new capital and expand the overall pool of financial resources for effective service providers. Although philanthropy can finance PFS activity, engaging the capital markets through SIBs can bring significant new resources to the social sector.

Toward Improved Performance in the Social Sector

SIBs appeal to impact investors who believe that private-sector discipline can drive improved performance in service provision. As they do with traditional investments, investors in SIBs conduct rigorous due diligence. They study the evidence base behind the intervention and assess the provider's ability to scale up program activities or replicate the intervention in a new region. They examine the strength of the provider's management team, its financial health, and its historical performance in producing social outcomes for the target population. They also assess the credit risk of the payer government as well as whether the proper legislation has been sought to mitigate appropriations risk. Once a SIB is launched, investors expect their investments to be actively managed and decisions surrounding repayment to be based on accurate social and financial data and transparent performance metrics. Thus, an independent validator tracks and aggregates performance data to determine whether the intervention achieved target benchmarks and consequently whether investors will be paid.

SIBs resonate with some service providers' growing interest in data-driven management. Government and private funders increasingly expect providers to focus on producing outcomes rather than outputs. In response, some high-performing service providers have adopted data collection and performance management practices to better track results. Although these practices are far from universal, others are also conducting rigorous evaluation of their interventions, comparing program participants against a similar group of individuals who did not have access to the program (including using randomized controlled trials) to gain insight on whether outcomes are truly driven by program activities.

Impact investors can help accelerate this shift toward greater accountability, transparent reporting, evidence-based practice, and data-driven performance management. Data-driven providers with strong management and proven interventions are attractive candidates for investment via SIBs. Successful outcomes performance enhances a provider's ability to attract investment capital, creating a virtuous cycle.

As the SIB market develops, intermediary organizations may play a role similar to bridging entities involved in syndicating Low Income Housing Tax Credits. For example, intermediaries like the Local Initiatives Support Corporation and Enterprise Community Partners created pathways for corporate investors to invest in affordable housing for low- and moderate-income families through limited partnerships. These intermediaries structure investments, manage provider partners, provide reporting to investors, make course corrections as necessary, and invest in capacity building to strengthen the community development corporations.

Enabling Impact Investment in SIBs

In the SIB context, intermediaries may play similar functions aimed at enabling impact investors to place capital with confidence. Impact investors in SIBs will demand that providers pay attention to their financial and operational strength. They may look to intermediaries to assemble and support the various stakeholders to launch SIBs, raise the investment capital required, coordinate service delivery among providers, manage performance and investments, and provide reporting to investors over the life of the investment. Intermediaries may also manage the other financial risks involved in the transaction, such as the risk that investors fail to meet their funding commitments or that the government fails to appropriate funds when target social outcomes are achieved. They play an important role to ensure that the collective social objectives are achieved and that value for government and financial returns to investors are maximized. Specialized SIB intermediaries or organizations with financial or subject-matter expertise could play these roles alone or in combination.

Foundations and other grantmakers can help catalyze the participation of impact investors in SIBs by playing four key enabling roles. First, they can provide funds to test new ideas and create an evidence base of what works in various service program areas. Second, they can provide capacity-building resources to help providers implement rigorous measurement and performance management practices. Third, they can fund a portion of the intermediary cost required to bring SIB transactions to market. Finally, they can provide credit enhancement to lower the risk profile for impact investors (which also decreases the cost of capital for the government or other payers) and demonstrate confidence in the intervention and provider.

Credit enhancement is especially important in the current SIB market. At this early stage, the market is led by "impact-first" investors who are willing to accept below-market returns. But even these investors require protection against the risk of capital loss associated with an untested financial mechanism and the underlying model and execution risks in the transaction. Accordingly, some form of capital protection makes SIB investments more attractive. The need for credit enhancement and other risk-mitigating approaches is even greater if SIBs are to pass the test of US financial institutions subject to the Community Reinvestment Act and other "finance-first" investors. SIBs that leverage grant funding or program-related investments to build in a tranche structure, first-loss reserve, or other form of credit enhancement may be particularly attractive to these investors. For example, the guarantee provided by Bloomberg Philanthropies in the New York City SIB transaction helped mitigate risk and attract Goldman Sachs.

The Potential of Social Impact Bonds

By drawing on large pools of private investment capital, SIBs have the potential to help social service providers access flexible, patient working capital at a scale that eclipses traditional funding sources. SIBs are not a one-size-fits-all solution: there are currently a limited number of areas where proven interventions, strong organizations, and opportunities to invest in prevention programs and create public value coincide. Yet, the size of current challenges in social service provision is immense. For example, a recent McKinsey & Company report on SIBs estimated that US government spending on remedial services for the homeless totals $6–$7 billion annually.[4] A high prisoner recidivism rate drives national corrections spending of more than $70 billion each year.[5] Homelessness and prisoner recidivism provide examples where SIBs have the potential to improve service delivery and effectiveness. There is also potential for SIBs to be beneficial in the areas of improving labor force participation for hard-to-employ populations, promoting healthy aging, and managing chronic diseases such as diabetes and asthma.

Philanthropy and government will continue to be vital sources of funding for the social sector. SIBs can complement this funding by serving a niche purpose: providing predictable, long-term capital for evidence-based organizations aiming to significantly expand their programs. By redirecting public spending from remediation to prevention and imposing greater discipline on social service delivery, SIBs have the potential to unlock short-term savings and long-term value at scale, a revenue stream by which government could use to repay investors. The concept is gaining momentum across the nation and around the globe as innovators seek ways to fund preventative programs addressing complex social problems. Though still in its infancy, the SIB model offers a promising new financing tool with the potential to improve the lives of individuals and communities in need.

Luther M. Ragin, Jr. is the chief executive officer of the Global Impact Investing Network (GIIN). The GIIN is a nonprofit organization dedicated to increasing the scale and effectiveness of impact investing. Prior to joining the GIIN, Luther served as vice president for investments at New York-based F.B. Heron Foundation from 1999 to 2011. He oversaw the Heron Foundation's endowment, building a portfolio of more than $260 million, steadily increasing the impact investing allocation to more than 40 percent while maintaining competitive, risk-adjusted financial returns. He holds a BA and Master of Public Policy from Harvard, and is a graduate of Columbia University's Executive Program in Business Administration. He is a member of the Board of Directors of Social Finance, Inc., the GIIN, and the Threshold Group. He is also an adjunct lecturer in public policy at the Harvard Kennedy School and a senior research fellow at the Hauser Center for Nonprofit Organizations.

Tracy Palandjian is the chief executive officer and co-founder of Social Finance, Inc., a 501(c)(3) organization dedicated to mobilizing investment capital to drive social progress. Social Finance develops innovative financing solutions that harness the power of the capital markets to serve individuals and communities in need. Prior to Social Finance, Tracy was a managing director for 11 years at The Parthenon Group, a global strategy consulting firm, where she established and led the Nonprofit Practice. She graduated magna cum laude from Harvard College and holds an MBA with high distinction from Harvard Business School where she was a Baker Scholar.

4 McKinsey & Company, "From Potential to Action: Bringing Social Impact Bonds to the US" (2012), available at http://mckinseyonsociety.com/downloads/reports/Social-Innovation/McKinsey_Social_Impact_Bonds_Report.pdf

5 Ibid.