Social and Development Impact Bonds

A financial instrument that allows private (impact) investors to upfront capital for public projects that deliver social and environmental outcomes. If the project succeeds, the investors are repaid by the Government (Social Impact Bonds) or an aid agency or other philanthropic funder (Development Impact Bonds) with capital plus interest. If the project fails, the interest and part of the capital is lost. The solution can align incentives between impact investors and society: investors support social projects and benefit when results are achieved. The approach is also referred to as pay-for-success in the United States and as a social benefit bond in Australia.

Key words: Inclusive businesses; impact investment; public-private partnership; pay-for-success; social benefit bonds

How does it work?

The Social Impact Bond (SIB) is a public-private partnership where one or more investor(s) provide “upfront” capital for the realization of public projects that generate verifiable social and/or environmental outcomes. Under a typical model, the Government contracts an intermediary (or project sponsor) to implement a social/environmental project in exchange for a promise of a payment contingent on the social outcomes delivered by the project. The intermediary will raise the capital for the project—hence use of the term bond—from commercial and/or philanthropic investors. It will then contract a service provider to deliver the project’s outcomes. If the project fails to deliver, the Government does not pay and the investors will lose part or all of their capital. If the project is successful, the Government pays the intermediary and investors. The objective is to:

- Align impact investment with measurable social and environmental outcomes;
- Grant affordable access to capital to public projects, particularly for preventive and conservation measures;
- Provide greater certainty on revenues for the execution of public projects thanks to the frontloading of all required resources; and
- Introduce rigorous approaches to performance management by closely link payments with performance—refocusing the social sector on outcomes and ensuring public resources are well spent.

The SIB thus formalizes a performance-based payment scheme. In the literature it is also referred as “payment for success”. The SIB is characterized by the framing of the partnership around a specific financial vehicle, a bond or debt obligation. In addition (http://www.brookings.edu/~media/Research/Files/Reports/2015/07/social-impact-bonds-potential-limitations/Impact-Bondsweb.pdf?la=en) and as distinct from other models of public-private partnership: 1. financing is provided upfront rather than when results are attained; 2. the projects financed are required to report on outcomes as opposed to outputs, granting the service providers greater flexibility to iterate in pursuit of better performance; and 3. Differently from traditional bonds, SIB are intended to improve the delivery of services as opposed to physical infrastructure (e.g. support services for the homeless or prisoners, child care, ecosystems conservation, etc.).

The original rationale of SIBs was to support projects that—if successful—would have resulted in cost-savings for the Government that are large enough to repay the initial investment (capital plus interest). Future cashable savings are to be preferred to more abstract valuations of social outcomes, given the requirement to pay back investors. However, the SIB should wherever possible identify the full benefits to the society of the challenge being addressed, trying to establish a value for the social outcomes sought (http://www.bridgesventures.com/wp-content/uploads/2014/10/ChoosingSocialImpactBonds_APractionersGuide.pdf). The first SIB was launched in the UK to fund the rehabilitation of ex-prisoners from Peterborough jail and reduce recidivism. Social Finance—the intermediary/sponsor—raised approximately US$8 million from 17 investors, which was invested in the prison’s re-entry service programme. The focus was on offering support to respond to the immediate needs of an offender and family before and after release from prison, including accommodation, medical services, family support, employment and training, benefits and financial advice (for a video presentation follow this link).
The design of a SIB can be articulated in 6 steps (adapted from performance mechanism for improved rhino conservation at selected sites in South Africa, Kenya and Nepal. London to address social challenges in Latin America. Finally, UNDP, the Global Environment Facility, the Impact Bonds financing model in Latin America and the Caribbean.

Most recently, SIBs were adapted to aid programmes with the payor being a donor agency instead of the Government. The term (http://www.brookings.edu/~media/Research/Files/Reports/2015/07/social-impact-bonds-potential-limitations/Impact-Bondsweb.pdf?la=en) DIB is used when: 1. The implementation takes place in a developing country and; 2. A donor agency or philanthropy is the outcome funder/payor. In Official Development Assistance, DIBs are categorized (http://r4d.dfid.gov.uk/pdf/outputs/misc_EcoDev/DIB_Sudy_Final_Report.pdf) as one of the three types of payment by results along with Results Based Aid and Results Based Financing. In developing countries, public authorities might not be in a position to pay for improved social/environmental outcomes and would need to rely on external assistance. Although several DIBs are at an advanced stage of design, only two have been completed, one in India on children’s education and one in Peru on sustainable coffee and cocoa production (http://www.fastinternational.org/news/cocoa-and-coffee-production-by-indigenous-ashaninka-people/). The latter, under the initiative of the Rainforest Foundation UK, the Common Fund for Commodities and the Schmidt Family Foundation, supports indigenous livelihoods and rainforest conservation in the Peruvian Amazon Region. Moreover, The Department for International Development is working on a DIB to tackle sleeping sickness in Uganda, while the IADB (http://www.fomin.org/en-us/Home/News/PressReleases/ArtMID/3819/ArticleID/1097/MIF-to-test-innovative-Social-Impact-Bonds-financing-model-in-Latin-America-and-the-Caribbean-aspx) has announced a US$5.3 million “SIB facility” to address social challenges in Latin America. Finally, UNDP, the Global Environment Facility, the Zoological Society of London (https://www.zsl.org/conservation-initiatives/animals-on-the-edge/rhino-impact-bond-project) and other partners are designing a multi-country DIB to save rhinos in Africa and Asia. The initiative will test an innovative pay-for-performance mechanism for improved rhino conservation at selected sites in South Africa, Kenya and Nepal.

The design of a SIB can be articulated in 6 steps (adapted from Social Finance (http://socialfinance.org/how-pay-for-success-works/)):

1. Form a public-private partnership on a priority subject area. The Government defines in the first instance the desired social or environmental outcomes to be prioritized. It usually works with the intermediary, service provider(s) and forerunner investors to conduct pre-feasibility assessments.

2. Develop a detailed project and outcome metric. The intermediary works with the Government and the service provider(s) to design a payment for success metric, i.e. the metric for which payments will be released by the Government to the investors. Simplicity and manageable costs of measurement are key considerations. The intermediary usually drives the design, negotiation, and structuring phases.

3. Mobilize capital. The intermediary raises capital from impact investors and from philanthropy to provide upfront funding to the service provider in order to execute the project. The intermediary might also engage third parties in order to offer a partial guarantee to investors.

4. Deliver services. The service provider executes the project. The intermediary is responsible for oversight, performance management, course corrections, financial management and investor relations.
5. **Validate outcomes.** An independent evaluator measures the outcomes achieved by the project on the basis of the predetermined metric. The project might or might not achieve its stated outcomes.

6. **Release of payments.** When successful and based on the evaluation’s results, the Government repays the upfront capital plus an interest. If the project does not achieve its outcomes, there is no payment.

The set-up of a supporting legal environment (e.g. treatment of investment in SIBs as donations in case of loss) and the degree of Government support to SIBs is critical in early market expansion. In order to spur innovation in public service delivery, the UK has established impact bond funds (i.e. the Innovation Fund (https://data.gov.uk/sib_knowledge_box/department-work-and-pensions-innovation-fund) and the Fair Chance Fund (https://data.gov.uk/sib_knowledge_box/fair-chance-fund)) to finance a larger number of SIBs. In the process, the Government had identified a list of priority outcomes and prices it was willing to pay for each outcome. The prices were arrived at by research over the estimated cost-savings related to reduced (future) public assistance. The United States set up a similar facility, the Social Innovation Fund (http://www.nationalservice.gov/programs/social-innovation-fund/our-programs/sif-pay-success/pay-success-national-evaluation), in 2014 to conduct feasibility studies and support transaction development.

**Stakeholders**

- **Outcome funder:** The Government or any other outcome funder(s) is responsible for paying back the principal and interest if the pre-determined outcomes are achieved. In a DIB the donor agency will repay the investor(s) instead of the Government.

- **Intermediary/project sponsor:** Receives the loan from the investor(s) and allocates the same to the service provider for project execution. The intermediary issues the debt and manages relations with investors, service providers, etc. If the intermediary is not a financial institution (e.g. an international organization or a NGO), it can buy the financial structuring services from the market. The intermediary is responsible for determining the project’s outcome metric. The intermediary will later focus on monitoring, service improvement and delivery of results.

- **Investor(s):** institutions or individuals willing to upfront capital in the form of a loan or other similar contractual arrangement to the intermediary or the special purpose vehicle created to manage the SIB. The investors accept the financial and operational risks of the project in exchange for an interest. Impact investors include foundations (e.g. CAF Venturesome (https://www.cafonline.org/charity-finance-fundraising/borrowing/social-investment/caf-social-impact-fund), Impetus Private Equity Foundation (http://www.impetus-pof.org.uk), Schmidt Family Foundation (http://tsffoundation.org), etc.), funds (e.g. Bridges Ventures (http://bridgesventures.com), Big Issue Invest (http://bigissueinvest.com), the FSE Group (http://www.thefsegroup.com), banks (e.g. Goldman Sachs (http://www.goldmansachs.com/our-thinking/pages/social-impact-bonds.html), Bank of America (http://baml.bankofamerica.com/email/doc/Veterans-Impact-Study-final.pdf)) and individuals.

- **Guarantors:** Third party who contributes to the partnership by offering a loan guarantee—often as a grant—to reduce the investor’s risks. A few of the first SIBs in the United States had guarantors, such as Bloomberg Philanthropies and The Rockefeller Foundation (https://www.rockefellerfoundation.org/strategic-approach/innovation/#social-impact-bonds). The SIB might also establish a multi-layered capital structure featuring senior investors, subordinate investors, recoverable grants, non-recoverable grants, and guarantors. Guarantees have covered from 9 to up to 75 per cent of the capital.

- **Service provider(s):** independent government entity, cooperative, NGO or private enterprise that executes the interventions required to achieve the desired outcomes. It signs a contract with the intermediary.

- **Evaluator:** the entity (e.g. consultancy, research institution, university) requested to confirm the achievement of the outcomes required to release repayments.

- **Beneficiary:** the population that benefits from the project financed by the SIB.

**Potential in monetary terms (revenues, realignment or savings)**

Despite growing, the market for SIBs/DIBs is still limited in value: approximately (http://www.socialfinance.org.uk/database/) US$200 million of investment has been committed to SIBs. The largest single transactions were made in the United States - New York State (US$13.5 million) and Massachusetts (US$18 million) for prisoners’ rehabilitation. In 2013 the Massachusetts State launched a SIB to help youth graduating from the juvenile justice system. Goldman Sachs, the Laura and John Arnold Foundation, New Profit, The Boston Foundation, The Kresge Foundation, and Living Cities provided US$18 million in grants and loans to finance the deal. If the project successfully decreases incarceration rates, the State will provide up to US$27 million in payments to the sponsors and investors.
Besides the UK and US, SIBs were issued in Australia, Belgium, Canada, Germany, Israel and Netherlands. In 2016 (http://www.brookings.edu/~media/events/2016/02/29-impact-bonds/20160229_social_impact_bonds_transcript.pdf) over 56 SIBs (31 in the UK, 11 in the US, 8 in Europe, 3 in Australia, 2 in Canada, and 1 in Israel) and two DIBs have been designed and 60 are being negotiated, half of which are in developing countries. While the majority of SIBs have a value of under US$5 million, they can reach over US$30 million.

The size of the impact investors market is estimated (https://thegiin.org) at US$77.4 billion of assets under management. If it grows to 1 per cent of total assets, it would reach US$2 trillion. To attract this bigger pool of capital seeking investment opportunities, increasing upside or reducing downside risks is likely to be necessary. So far, SIBs have been piloted by a limited group of impact investors who were willing and able to take disproportionate risks. The establishment of multi-tier capital structures, where investors are provided with differentiated risks and provisions, would also help to develop the market and attract new capital. In the short term, venture philanthropists will continue to be the most closely aligned investors for SIBs/DIBs.

Additional Government support will be critical in expanding and standardizing the market. In the UK the Government (https://data.gov.uk/sib_knowledge_box/) (Cabinet Office and the Big Lottery Fund) has established two funds - The Social Outcomes Fund (£20m) and Commissioning Better Outcomes (£40m) - to directly support the development of SIBs. These funds paid a proportion of outcomes payments (circa 20 per cent) for SIBs. In the USA a similar fund was proposed.

### When is it feasible?

#### Legal and/or other feasibility requirements

The legal requirements vary from country to country based on how the law treats hybrid investments and loan issuances. In addition to legal considerations related to the structuring of the financial instrument, there are feasibility requirements connected to the assessment of SIBs’ underlying projects and outcome metrics. In particular assessment of the following elements should be considered:

- The payor willingness to engage in impact bond negotiations is the most important element, if not a pre-condition.
- Existence of a robust metric to measure performance over the achievement of outcomes. The milestones for releasing payments to investors must be simple, verifiable and realistic. Evidence of success in achieving similar outcomes should be carefully assessed.
- Reasonable timeline to achieve the outcomes.
- Reasonable interest from the impact investor community. Market research over prospective investors is required.
- Availability of service providers able to meet the challenges and rigors of the impact bond models.

#### Minimum investment and running costs

The investment requirement of a SIB is dependent on the project to be financed. In addition to the capital amount to be raised from investors, there are transaction costs including, intermediary services, technical assistance, evaluation, and legal fees. These transaction fees may be paid from the capital raised. Being a young market, the start-up costs of SIBs have been high despite pro bono contributions. As the market expands, these costs should be reduced by both economies of scope (learning by doing and standardization) and scale (marketing, average size of deals). The development of public innovation and SIB funds such as the one in the UK (https://www.gov.uk/government/publications/innovation-fund-for-young-people-provider-guidance) and US will gradually allow for larger investments and reduce set-up costs.

The return on investment for most SIBs is set in a range that is lower than 7.5 per cent (possibly as low as 2 per cent). However, the SIB structure usually allows investors to obtain higher interest rates or premiums if the project is particularly successful. The highest maximum internal rates of return so far were 13 per cent for the Peterborough SIB—the first SIB—and 12.5 per cent for the New York state SIB.

### In what context/when it is more appropriate

The SIB may be an instrument of choice when a Government cannot invest in a social project despite the expectation of accruing both substantial cost savings and positive social/environmental outcomes. The Government might not be able or willing to invest in the first instance due to limited access to finance or the difficulty of accepting the project’s risks. SIBs are most appropriate:

- When focusing on areas of priority for both the public sector and investors;
The cost of the intervention can be offset by the potential cost savings; there is solid evidence backing the project’s outcome metric.

The payment for success model is theoretically applicable to developing and developed countries. However, the challenges related to the collection of data for the design and monitoring of the outcome matrix can be comparatively more difficult and costly in low income countries. The support of development partners, philanthropic bodies and international organizations will continue to be necessary for the development of the outcome matrix in lower income countries. These considerations are being reflected in the DIB model, where the outcome funder is a development partner.

What are the main risks and challenges?

Pros

- For government, the SIB can reduce or minimize the financial and operational risk while promoting investment in social/environmental projects. Similarly, it can stimulate innovation.
- For investors, the SIB offers a “mission-aligned” investment opportunity, as well as a potential return on investment.
- For service providers, the SIB offers access to upfront funding for the delivery of the services.
- For project execution, the SIB helps to introduce results-based management practices. Investment rigour can help to achieve higher standards in design and delivery: when an organization raises capital several million dollars, the analysis tends to be of higher quality than when applying for a grant.
- As a movement, it highlights the importance of achieving outcomes instead of focusing solely on the use of inputs.
- It creates space and a working modality for public-private partnerships and collaborations.

Cons

- Requires verifiable quantitative metrics, which are difficult to derive for a number of projects and might take several years to develop.
- Comparatively complex and time-consuming to set up. As soon as the metrics are established and awareness is raised, the costs of developing a SIB will be gradually reduced.
- The intricate structure of negotiations, coordination and implementation generate comparatively high administrative costs.

Risks

- If the outcomes are not achieved, the investors will lose their investment. The SIB is indeed a risk sharing mechanism where the Government transfers the risk of project execution to private investors. The underlying project risks are specific to the project (e.g., technology, counterpart, etc.) and require thorough assessment and management.
- Investors may demand and lobby for lower "success thresholds" so that they are sure to be repaid.
- Profit as incentives for investors may compromise social impact in exchange for greater revenues or lesser risks. Trade-offs exist in terms of the self-selection of projects by either the public commissioner or the intermediary between the need to attract investors versus achieving more ambitious goals and among investors when required to select which SIB to fund.
- The misuse of SIB and DIB labelling can damage the reputation of the instrument and the trust of the impact investment community. While compared to other financial instruments the risk is lower (due to the pillar role of the outcome matrix), the risk remains, particularly in case of a large expansion in the numbers of proposed SIBs.

How can the design be ameliorated to improve the impact?

The measurement of outcomes requires time and given that most of the SIBs were issued after 2013, the evidence is by definition limited to early findings. Recent research has indicated that impact bonds have the potential to contribute to the improvement of social service delivery though thus far the deals have been complex and time- and expertise-intensive. According to Social Finance (http://www.socialfinance.org.uk/wp-content/uploads/2016/07/SIBs-Early-Years_Social-Finance_2016_Final3.pdf), of the 22 SIBs having reported performance: 21 have reported positive outcomes, 12 have made outcome payments, and 4 have fully repaid investors. The outreach to beneficiaries varies
from a few hundred prisoners to over 18,000 children in India. The definition of the impact is determined at the beginning of the project, with the possibility of establishing multiple performance targets that constitute the core of this instrument. The information on intended impact should be accessible for all approved SIBs/DIBs.

The structure of SIBs is such that no public money is spent if there is no impact. As noted above, the City of New York’s SIB failed to meet the outcome target and therefore the City did not pay back Goldman Sachs. On the other hand, the Newpin Bond—Australia’s first social benefit bond from Social Ventures—produced a positive outcome: the project restored 66 children to their families (cumulative restoration of 62 per cent compared to a baseline of 25 percent). As a result, investors received a 7.5 per cent return in the first year and an 8.9 per cent return in the second.

The structure and incentive-system of SIBs is designed to favour the financing of projects with high social and environmental impacts. The following considerations could be taken into account to improve their impact and scale:

- Pursue economies of scale. Since many projects financed by SIBs are relatively small, continued philanthropic support is likely to be required, particularly in meeting the sunk costs of intermediation, such as the development of outcome matrices. However, if the market reaches a sufficient size these resources could be freed again for grant making activities. The establishment of funds dedicated to SIBs can accelerate this process.
- Balance between projects that are innovative and projects that have a larger impact.
- Clear identification of target beneficiaries can help simplifying the outcome metric and delivering more focused and impactful interventions.
- Increase the elements of additionality. The sources of revenue and capital related to the SIB should be from previously untapped sources.
- Reinforce the link between returns on investment and impact, including top-up payments for exceptional results. The Government should consider scaling up the original contracts that successfully delivered on outcomes. This option would increase the incentive of investors and service providers to deliver better.
- Ensure that the payments directly relate to the intended outcome (and include a longer-term outcome evaluation if necessary). This includes ensuring that the right metrics are in place to reward genuinely better outcomes.
- Learn from implementation and share lessons, including the identification of what drives better outcomes.

SIBs should be designed to provide the most value to the commissioners. This means pricing them in such a way so that the programme will deliver demonstrably better results than the commissioner would get from elsewhere.

**Guidelines and Case Studies**

**Detailed guidance**

- Social Impact Bonds: The Early Years (http://www.socialfinance.org.uk/sib-white-paper/)

**Case studies**

- Social Impact Bond at Greater London Authority (Homelessness/UK) (https://data.gov.uk/sib_knowledge_box/greater-london-authority-homelessness)
- For a list of SIBs in the US access the Pay for Success Learning Lab (http://www.payforsuccess.org/provider-toolkit/pfs-projects)
- For a global list of SIBs access the Social Finance database (http://www.socialfinance.org.uk/database/)
• Instiglio maintains a worldwide list of SIBs (http://www.instiglio.org/en/sibs-worldwide/) in developed and developing countries
We should reach a consensus on the fact that macroeconomic policies in low-income economies need to also jettison the conventional wisdom of undue restrictiveness.