Towards a new social economy

Blended value creation through Social Impact Bonds

March 2010

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Acknowledgements

The Social Impact Bond structure in this paper builds on the thoughts, ideas and support of others who we would like to acknowledge here.

Arthur Wood, then of Ashoka, talked to us in late 2007 about work he was doing on a 'Contingent Revenue Bond' in which the funders of specific social activity, in this instance developing sanitation in developing countries, would be split into capital financing for work on the ground and foundations that would pay for the results when measured. Arthur's original insight led to the structure that we now call the Social Impact Bond.

In 2008, David Robinson and Peter Wheeler talked to us about the work they began with the Prime Minister's Council on Social Action (CoSA) in 2007. They were interested in whether preventative activity could be funded from savings made in acute spending as a result of successful preventative work. CoSA led on the development of relationships with government. David and Peter provided us with continued access, support and advice as well as connecting us to the CoSA partner Allen and Overy who later became our legal advisors, providing over 300 hours of pro bono legal support for the development of Social Impact Bonds.

At around the same time Martin Brookes, of New Philanthropy Capital, invited us to join a meeting to consider whether financial structures could be developed to fund early intervention work. The meeting followed discussions with Graham Allen, MP for Nottingham, who posed the problem of how more resources could be devoted to early intervention. We were introduced to Edmond Curtin, now of Cadwalader, Wickersham & Taft LLP, a derivatives lawyer who later wrote the first draft term sheet for the Social Impact Bond, and Chris Egerton-Warburton, of Lion's Head Global Partners, who had structured the IFFIm immunisation bond and later helped us through the vital work of getting support from Treasury and an agreed accounting treatment.

Geoff Mulgan, of the Young Foundation, connected us to the stream of previous thinking that has occurred in the area, particularly around outcomes-based commissioning and reducing perverse incentives between government departments. As well as providing analysis and constructive challenge, Geoff connected us to senior policy makers and suggested the name "Social Impact Bond".

Without the support of these individuals and others, including the Indigo Trust and Mick Ridge at Frontier Economics, it would not have been possible to develop this work.

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Social Finance requests that their role in leading the development of Social Impact Bonds is acknowledged in any future publications or press references.

Foreword

We started developing Social Impact Bonds in 2007 when thinking through how to increase the availability of finance for improving social outcomes and how to reduce the uncertainty of funding for social services in the UK.

Social Impact Bonds have since made up a significant proportion of our work. This paper is an attempt to capture and share some of what we have learnt while developing the initial Social Impact Bond pilots.

Social Impact Bonds raise funds from non-government investors to pay for the provision of services. If the services make a difference and social outcomes improve, investors receive success payments from the public purse. The size of these payments depends on how successful the services are.

We believe that linking investors' financial interests with better social outcomes is an effective way to improve society. As we explore in this paper, Social Impact Bonds could help to drive the creation of a more diverse, innovative and evidence-based social economy in the UK. This in turn could lead to a substantial increase in the availability of non-government investment for the development of effective social services.

Those interested in payment by results and outcomes-based commissioning should note that Social Impact Bonds overcome two of the main constraints of traditional outcomes-based contracts:

- By contracting with investors rather than service providers, Social Impact Bonds facilitate the use of a number of service providers to deliver better social outcomes rather than assuming that a single organisation can succeed across the board; and
- By using investment to fund the delivery of services up front, Social Impact Bonds enable social sector organisations to participate in outcomes-based contracts that would otherwise require them to fund their activities before outcomes payments are made.

For the public sector, Social Impact Bonds represent a relatively risk-free way to address costly health and social problems. It stands to benefit from the development of new and improved social services, but only has to pay if the services have a genuine impact.

For investors, Social Impact Bonds offer an opportunity to improve society and to potentially make an attractive financial return.

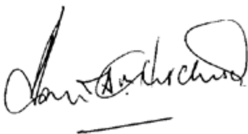
Social Impact Bonds may be particularly useful for funding preventative services. There is a growing body of evidence that society could benefit from such services – if interventions are effective, the public sector can spend less money on expensive services such as prisons, acute medical care and drug rehabilitation.

Historically, the public sector has struggled to fund preventative services as they require it to take a risk – it could end up funding not only the costs of preventative services, but also the costs of further services to deal with social problems if the preventative services fail. As Social Impact Bonds transfer the risk that interventions fail to investors, they should make it easier to address social problems earlier, generating benefits for both public sector budgets and wider society.

The first section of this paper explores why a new social economy is needed and the role that Social Impact Bonds could play in stimulating its creation. The second section draws on Social Finance's work developing Social Impact Bond pilots to explore practical considerations around their use and application. In both we temper our enthusiasm by being clear about what we still don't know and what is under development.

Our vision is that, over time, Social Impact Bonds will become a significant source of finance for effective services addressing a range of social issues, delivering attractive returns to a wide range of investors and improving people's lives.

We welcome thoughts on this paper and hope that you will share our enthusiasm for the opportunities that a new social economy could bring.



David Hutchison
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March 2010

Social Impact Bonds[1]

A Social Impact Bond is a contract with the public sector in which it commits to pay for improved social outcomes. On the back of this contract, investment is raised from socially-motivated investors. This investment is used to pay for a range of interventions to improve the social outcomes. The financial returns investors receive are dependent on the degree to which outcomes improve.[2]

By enabling non-government investment to be raised, Social Impact Bonds should lead to greater spending on services that prevent costly health and social problems.

Take, for example, re-offending by released prisoners, which costs government millions of pounds a year.[3] A Social Impact Bond could be used to raise money to pay for the expansion and coordination of services to reduce re-offending. The more effective these services are at achieving the target outcome, the higher the blended (social and financial) return investors would receive.

Social Impact Bonds are a unique funding mechanism in that they align the interests of key stakeholders around social outcomes:

Government – The public sector pays only for positive outcomes by releasing a proportion of savings to reward Social Impact Bond investors. Success payments are calibrated such that, if Social Impact Bond-funded services improve outcomes, these payments will cover the costs of the interventions

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[1] Social Finance defines 'Social Impact Bond' as *"a financial vehicle that brings in non-government investment to pay for services which, if successful, deliver both social value and public sector cost savings. Investors receive a financial return from a proportion of the cost savings delivered."* It should be noted that other organisations, most notably the Young Foundation, have used the term 'Social Impact Bond' to apply to a broader range of financial vehicles that align incentives between government departments, but do not bring-in external investment for social benefit. 'Social Impact Bond' is not used in this way in this document.

[2] To this extent Social Impact Bond contracts are not 'bonds' in the conventional sense of the word. In FSA terms, bonds offer a fixed return to investors over a fixed period of time. While Social Impact Bond contracts operate over a specified period of time, in terms of investment risk they are more similar to that of an equity investment. The financial returns that investors will receive varies according to their success in achieving the social outcomes specified in the Social Impact Bond contract.

[3] A recent report by the National Audit Office reported that re-offending by short-sentenced offenders costs the public sector £286 million, and the UK economy £7–10 billion each year. (*Managing Offenders on Short Custodial Sentences*, National Audit Office, 2010).

and enable investors to make a return. Investors carry the risk that funded interventions may fail to improve outcomes.

Social investors – Investment in Social Impact Bonds by commercial investors, trusts and foundations, and High Net Worth Individuals offers an opportunity to generate a blended (social and financial) return on investment. The social and financial imperatives are aligned – investors receive greater financial returns as the social return improves.

Social service providers – Social Impact Bond investment is used to pay up front for the delivery of services enabling providers of all sizes to participate in generating success. Providers are encouraged to innovate to achieve the best possible outcomes for the target population. The focus is on the value for money that social service providers can offer in terms of improved social outcomes, not on the cost of services alone.

We believe that Social Impact Bonds represent a significant step forward. However, they are also only one way of funding better social outcomes and may not be an appropriate funding mechanism for every social problem.[4]

Because Social Impact Bonds require the engagement of a number of stakeholders, they can be complex to set-up. We believe that, in the current economic environment, Social Impact Bonds are feasible if:

- They address a social problem that has high costs for the public sector and can be measured;
- The costs are such that, if avoided, they will reduce the public sector's expenditure;
- It is possible to identify the individuals that could benefit from the services funded by Social Impact Bond investment;
- Interventions that would deliver improved social outcomes are known; and
- The interventions cost substantially less than the public sector savings that would result from improved social outcomes.

[4] Appendix 1 outlines a framework for analysing whether or not a Social Impact Bond is appropriate for funding solutions to a particular social issue.

As the economic situation improves, we believe government may become interested in the use of Social Impact Bonds to address social issues that would generate significant social value, but may not lead to easily identifiable public sector savings.

We believe that Social Impact Bonds have considerable potential to drive significant improvements in social outcomes in the UK.

SECTION 1

Towards a new social economy

1. The case for change

Britain's social economy is changing. As social needs become more diverse and, in places, acute there is increasing recognition that often the most effective services are those that are tailored to local needs. Solutions to unemployment, for instance, may be very different in former industrial cities like Hull, rural areas like Cornwall and areas with large immigrant communities like East London. The value of local solutions is recognised by all major political parties in the UK.

A central concern has been to secure better value for money from public services, a search that is about to become more urgent as the focus shifts to reducing public debt over the coming years. Across the political spectrum policy makers are looking for ways in which the same or more can be squeezed from a shrinking pot.

In such a wintry economic climate, the creation of an effective social economy is a prerequisite for success. While the last few decades have seen numerous public sector initiatives aiming to create a market in effective services,[5] substantial barriers to the effective operation of the social economy remain.

This section examines some of these barriers, before moving on to explore the role that Social Impact Bonds could play in creating a new social economy. We then review the role that the public sector and socially-motivated investors may play in enabling this vision.

Too little, too late

Prevention is generally cheaper than cure, which means that interventions that tackle social problems early could deliver financial savings to the tax payer in addition to a better society. There is considerable evidence that earlier interventions can improve quality of life. In the United States, for example, the Nurse Family Partnership that supports low income women has

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[5] Including encouraging competition between service providers, pooling of budgets between government departments and commissioning for outcomes rather than outputs.

been found to be a highly cost effective way to improve future prospects for children.[6]

The public sector currently spends significant sums treating the symptoms of social problems, but considerably less tackling their causes.[7] Budgets are so tied-up in crisis expenditure that there is not enough available to tackle the underlying causes. Even where larger sums have been devoted to prevention (such as Sure Start and health screening programmes) these have been small compared to what is needed.[8]

The risk that early intervention programmes may not improve social outcomes makes it difficult for government to increase preventative spending. Equally, existing statutory duties to address social problems once they arise (dealing with school truants, offenders on probation, children with behavioural problems, etc.) necessarily become budget priorities ahead of new steps in prevention. As the Vice Chair of the Prime Minister's Council on Social Action, David Robinson, explains:

> *"It is difficult to get rid of the ambulance at the bottom of the cliff in favour of a fence at the top."*

Without access to additional finance, the public sector can find itself in a negative spending cycle in which worsening social outcomes lead to an ever growing need for resources to be spent on expensive crisis interventions (Figure 1.1 overleaf).

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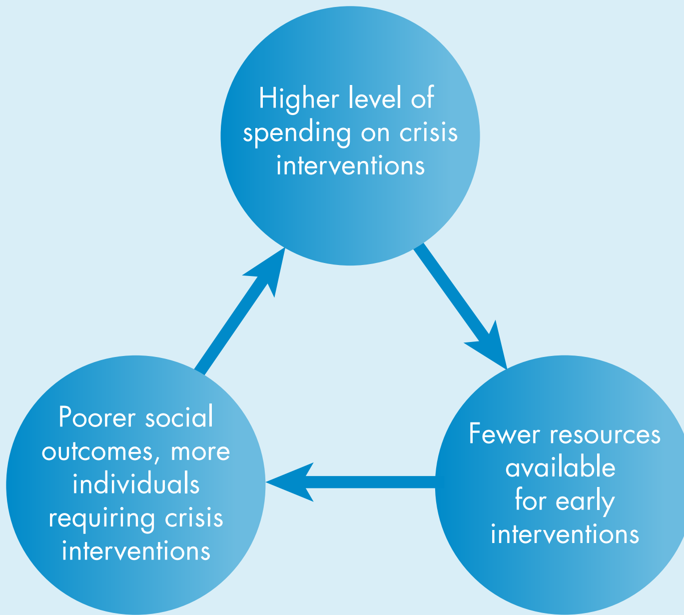
6 For every dollar spent, there were benefits to the taxpayer of an estimated $2.88. *Benefits and costs of prevention and early intervention programs for youth,* Washington State Institute for Public Policy (2004).

7 Of the £92 billion that central government devotes annually to health in England, only 3.7% goes on prevention (*Prevention and Preventative Spending,* Health England, 2009). Against £1.45 billion spent each year on truancy and school exclusions, government allocates just £111 million to prevent them (*Misspent Youth,* New Philanthropy Capital, June 2007; *Improving school attendance in England,* National Audit Office, 2005).

8 For instance, Action for Children and NEF have called for an additional £191 billion in early intervention over 10 years. Without this, they estimate the cost to society over the next two decades would total almost £4 trillion. (*Backing the Future: why investing in children is good for us all,* Action for Children/NEF, 2009).

Figure 1.1 – Catch 22: Negative spending cycle caused by low levels of early intervention expenditure



Problems of prevention

One of the reasons that the public sector doesn't currently spend more on preventative interventions is that prevention is complicated. It often requires public sector agencies to collaborate across departmental boundaries. Truly joined-up government has remained hard to achieve in spite of incentives towards pooled budgets, units that cross departmental boundaries and targets that are shared between departments.[9]

A central issue here is that the department that invests in early intervention often does not see the financial benefits of a programme's success. For instance, Local Authorities do not currently have a financial incentive to prevent offending. If given a custodial sentence, the costs of offenders are borne by the National Offender Management Service rather than the

[9] In 2009 nearly a third of targets were shared across departments (*The Art of Public Strategy,* Geoff Mulgan, 2009).

Local Authority. The Local Authority could even stand to make savings from reductions to local services (e.g. police, social services, etc.) if an offender goes to prison. It therefore has little financial incentive to improve outcomes.

Furthermore the financial gains from investment in prevention may not be realised for several years. In the meantime the public sector has to find funding, on top of its existing budgets, to pay for the preventative programmes. If the preventative interventions fail, the public sector will find itself paying for two sets of costs – the up front costs of the interventions and the ongoing costs of failing to prevent the social problem. This risk deters investment in prevention.

It is therefore unsurprising that government tends to underspend on preventative interventions, particularly when funding is tight.

Outputs not outcomes[10]

In recent years, the public sector has explored methods of increasing the cost-effectiveness of social services by contracting services out to organisations that can provide them at more competitive prices. It has also increasingly used targets as a way of directing and controlling public expenditure.

Targets aim to hold public sector agencies and sub-contracted service providers to account and are broadly equivalent to performance objectives in the private sector. However, public sector targets have tended to focus on inputs or outputs (which may or may not benefit people's lives) rather than outcomes (actual improvements in the lives of the client group). A youth training scheme, for example, might be evaluated on the basis of how many young people attend the training course (an input) or receive a Health and Safety certificate (an output). The hope (the desired outcome) is that better qualified young people will be more likely to find jobs. Too often such outcomes are not used to measure the success of such schemes or to judge whether or not to renew service provider contracts.

This trend is driven by the fact that contracting for inputs and outputs is simpler than contracting for outcomes. It is easier for a commissioner to measure and attribute outputs to a service provider – they can count the number of

[10] *Outputs* – the tangible results of an intervention (e.g. literacy certificates awarded or individuals attending a substance misuse centre). *Outcomes* – the desired impact of an intervention (e.g. individuals securing and retaining employment).

Health and Safety certificates awarded. It is more difficult to attribute an outcome, such as employment, to the work of one agency as inputs from multiple organisations may be required to deliver a positive outcome.

Nevertheless, an input- or output-focused approach can undermine the delivery of effective public services. Public sector commissioners are encouraged to focus on defining the methods of service delivery rather than the impact of those services on clients' lives. Specifying service delivery in this way can leave little flexibility for service providers to tailor their services to local needs and develop locally-appropriate solutions.

A focus on inputs and outputs can also create the wrong incentives for service providers, driving them to find more cost-effective ways of achieving the agreed outputs without enough thought for the desired outcomes. For instance, training providers may have an incentive to put young people through a Health and Safety certification because they are paid on that basis. To reduce costs, providers may supply the minimum training necessary for young people to pass. The provider is unlikely to provide additional career support as they are not financially rewarded for helping young people to find employment. Consequently, inputs- and outputs-based commissioning can fail to deliver the desired policy goal: in this case reduced youth unemployment.

Finally, output-based contracts encourage commissioners to focus on the cost of the service being delivered rather than on the value it creates. Output-based contracts tend to rely on 'cost-plus' calculations, in which the commissioner agrees the cost of delivering the agreed outputs and pays the cost plus a small premium. Unfortunately, this does not take into account the wider value of the service. Costs become the main criterion for awarding contracts to service providers, rather than the value to the public sector or wider society. As a result, commissioners have an incentive to select the lowest cost provider rather than the one offering the best overall value.[11] The quality of public services may suffer.

[11] EU procurement rules may be a further complication.

Social sector organisations[12] struggle to compete

Ensuring effective public service delivery is complex as the service user generally does not pay for the services themselves.[13] This means that the market forces that drive quality of services in the private sector do not operate. An offender on a publicly-funded literacy course cannot choose to change providers in the way that we might change supermarkets if the quality of produce at our usual store declines. In an attempt to compensate for the absence of market forces, the public sector has developed complex commissioning practices that seek to select the most effective service providers.

As commissioning for outcomes is hard, contracts tend to be won on the basis of the proposed cost of delivering outputs rather than the cost-effectiveness of delivering outcomes. This system favours larger, often private sector, providers who compete by providing lower cost services, often to the easiest to work with individuals.[14] Social sector organisations, that may try to negotiate a broader, more flexible set of services for their service users, often lose out. They may be further disadvantaged by contracts that pay for services in arrears, and hence require significant access to up front funding to cover the costs of operations before payment.

This is a shame as social sector organisations are often established to deliver to the needs of a specific target population. As a consequence their interests are often well-aligned with those of their service users. The public sector has become increasingly aware of the value that social sector organisations could add as providers of public services. However, as budgets tighten all service providers will be under increasing pressure to deliver lower cost services. If the focus on the costs of service delivery is not balanced against an equally strong focus on generating positive social outcomes, the quality – and ultimately value – of services will suffer.

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[12] Charities, social enterprises and social purpose businesses.

[13] The move towards personalised budgets for social care is an example of emerging work that seeks to correct this mechanism.

[14] It should be noted that these practices can also be a problem within outcome-based contracts where the success payments are small relative to the costs of intervention. For instance, a recent report on the Pathways to Work programme found that *"management pressure to focus on job ready clients was leading to less time being spent with clients who are further away from work."* (*The influence of outcome-based contracting on Provider-led Pathways to Work*, Department for Work and Pensions, 2010.)

Public services would improve if the social sector was strong enough to compete with private sector contractors to deliver better social outcomes and better value services. It would be improved even further if the commissioning process placed an emphasis on the social value of the service being commissioned.

Contracts that pay based on outcomes could create a more rational revenue stream for delivery agencies, aligning their income with their ability to deliver social value. Social sector organisations could benefit significantly from such a shift.

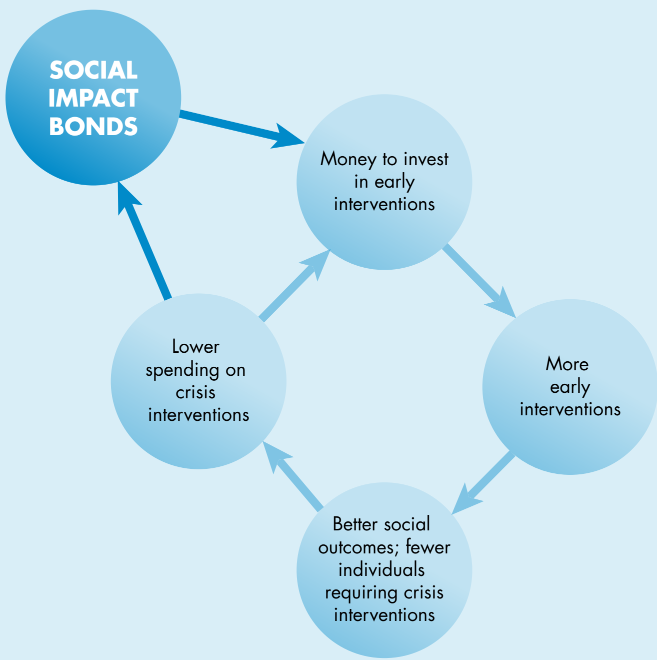
2. Towards a new social economy

We believe that an effective social economy has three defining characteristics:

1. A diversity of service providers;
2. A market discipline that rewards effective service providers; and
3. Availability of investment to enable effective service providers to develop and grow.

Social Impact Bonds support the development of a new social economy by addressing many of the problems outlined in the previous chapter. They seek to catalyse positive cycles of social impact and savings to the public purse by driving non-government investment into social outcomes at scale (Figure 1.2).

Figure 1.2 – Paradigm Shift: Social Impact Bonds catalyse positive cycles of government spending, improving social outcomes and reducing costs



This chapter explores the role that Social Impact Bonds could play in catalysing such a 'new social economy'.

Ensuring a broad diversity of service providers

A healthy social economy needs a wide variety of robust, high quality service providers. The recent public sector emphasis on using social and private sector providers has been focused around developing this diversity and moving away from public sector-only provision.

Unfortunately, as we noted in Chapter 1, current public sector commissioning practices tend to favour larger, often private sector, service providers. They also can be bureaucratic, favouring those with expertise in the commissioning process, over those with expertise in the services being commissioned. Over time this could limit the choice of potential service providers in the market. This, in turn, may reduce the pressure on the remaining service providers to manage their costs effectively and improve the quality of their services.

Social Impact Bonds could help to maintain a diversity of high quality service providers in a number of ways. Firstly, Social Impact Bonds create predictable revenue streams for social service providers. Because Social Impact Bond investors are focused on achieving the social outcomes, service providers will be selected to deliver services to the extent that they can demonstrate their effectiveness at working with a target group to achieve the target outcome. Their success at attracting funding will be based on their potential to achieve impact alone, not on the size or financial strength of their organisation, the cost of the outputs that they generate or their ability to comply with other conditions of public sector contracts. The value of local solutions to local problems would be recognised.

Secondly, the outcomes focus of Social Impact Bonds encourages complementary service providers to collaborate with each other. Improving people's lives can require a variety of interventions. To assist young people into jobs you may have to work with them on their literacy, help them off drugs, address mental health problems and encourage them to travel further to work than they expect. Agencies may specialise in only one of these services, but currently have to compete with each other for contracts that

would be more effectively delivered if they worked together. Because Social Impact Bond investors are interested in achieving the best social outcomes, Social Impact Bond investment would be used to fund services from a number of specialist service providers. This would enable organisations to focus on delivering and developing their core strengths.

By creating the conditions for a diverse economy of private and social sector service providers, Social Impact Bonds could help to create a positive culture of competition and innovation that should safeguard both the quality of services and value for money.

Creating a market discipline that enables effective service providers to thrive

In the private sector the discipline that enables the most effective organisations to thrive and grow is the operation of market forces – only organisations that provide services to users at a price that they value will thrive. Similarly, in an effective social economy, socially-driven spending must reflect the value rather than the cost of commissioned services.

Social Impact Bonds, like other forms of outcomes-based contract,[15] align public sector funding with improved social outcomes – the amount that the public sector pays for a service is determined by the social value (the extent to which outcomes have improved). If social outcomes are not improved, the public sector is not required to pay. Outcomes-based contracts therefore have the potential to generate considerable improvements in the cost-effectiveness of public spending – payments are only made for effective services.

As we noted earlier, however, the social sector may be disadvantaged when outcomes-based contracts are used as they do not have access to the funding they need to deliver services. This creates a bias in the market meaning that less effective service providers with better access to funding would be more likely to win contracts. Social Impact Bonds correct this bias as the cost of services is paid by Social Impact Bond investors up front. Even the smallest social sector organisations could be contracted to provide services if they can demonstrate evidence of their effectiveness at improving social outcomes.

[15] A comparison of Social Impact Bonds with outcomes-based contracts and government debt can be found in Appendix 2.

Creating a market discipline of this kind within the social economy should bring with it a number of other benefits.

At present, incentives to improve social service delivery tend to be weak. Given its accountability to tax payers for public spending, the public sector does not want to waste money on ineffective interventions. Outcomes-based contracts shift this risk – in the case of Social Impact Bonds, from the public sector to investors.[16]

Social Impact Bond investors should be incentivised to fund the development of innovative and improved social services as their financial returns are tied to the social impact of the interventions that they fund. As a result, in addition to the social outcomes that are achieved, Social Impact Bonds should generate considerable learning about the effectiveness of social interventions. This learning could be used to inform future rounds of public spending once the Social Impact Bond contract has ended.

Social Impact Bonds should also remove the disincentive for the public sector to address social issues early by shifting the risk that interventions fail onto non-government investors. By bringing new money into the system without increasing public debt, Social Impact Bonds should make it easier to develop and expand preventative services.[17] These services should catalyse the virtuous cycle of better social outcomes and public sector savings outlined in Figure 1.2. If budgets are stable, public sector savings could be used to fund further early intervention programmes or improvements in acute interventions. In budget-constrained times, they could enable the public sector to achieve more with less – a likely necessity over the coming years.

Finally, given the focus of Social Impact Bonds around outcomes, many of which may be shared or overlapping across departments, Social Impact Bond contracts could help to drive more joined-up working within the public sector at both a local and national level. A Primary Care Trust, for example, may decide to work with a Local Authority social care department to set-up a

[16] More standard outcomes-based contracts, like the Flexible New Deal that seek to reduce unemployment, transfer the risk from the public sector onto service provider organisations.

[17] Social Impact Bond investors fund the up front costs of interventions and provide working capital until outcomes are achieved. Government has no obligation to pay investors unless savings are made.

Social Impact Bond to raise investment targeting better health among older people. Both would stand to make savings if health outcomes improve, but neither has to commit funds unless savings are achieved. In this way, Social Impact Bonds could encourage greater collaboration between government agencies. Budget-holders would not have to risk their budgets up front; payments would only be made once collaboration had been shown to work and cost savings achieved.

Ensuring sufficient availability of funding to enable effective service providers to develop and grow

The fact that social sector income streams are hard to predict under current contracting mechanisms means that investment in the development of social sector organisations is limited. The result is a weak and fragmented sector that cannot deliver to society's needs as effectively as it could.

The availability of funding to enable effective social service providers to develop and grow is a function of the predictability of service provider income streams. Within the social economy this predictability is determined by two factors:

- The extent to which contracts for service provision are awarded on the basis of social value; and
- The degree of market transparency, enabling investors to make evidence-based decisions.

The first of these factors we have explored above. The more correlated contracts for service delivery are with the ability to demonstrate cost-effective improvements in social outcomes, the more funding is likely to be available to develop new and grow existing service provider organisations. A service provider that consistently delivers outcomes should be assured of ongoing funding.

The second, market transparency, refers to the availability of high quality research and analysis around both which interventions deliver outcomes most effectively, and which organisations are the most efficient at delivering these interventions.

The Washington State Institute for Public Policy has shown that transparency around the effectiveness of programmes can deliver long-term cost savings to the state and broader social benefits. For instance, investment in programmes recommended by the Institute for their effectiveness has led to a reduction in crime and, consequently plans for a new prison have been shelved.[18]

However, the development of effective measures of social impact is notoriously complex. Use of Social Impact Bonds could potentially speed up this process by increasing the incentive for social service providers to evidence the effectiveness of their interventions. Better evidence would improve their chances of becoming a service provider funded by Social Impact Bond investment.

Social Impact Bond-funded programmes would also provide a valuable opportunity to assess the interplay between different interventions to understand which interventions work for whom. The resulting learning could have a wide impact, influencing the development of services elsewhere.

The availability of rationally-allocated, impact-based revenue streams from Social Impact Bonds should create an incentive for grant makers and social investors to provide earlier stage funding to service providers to enable them to innovate and grow. Investors will know that if they finance an organisation that can demonstrate its impact, they stand a good chance of securing an income stream that will fund the delivery of services in the future.

[18] Correspondence with Social Finance, Steve Aos, Washington State Institute for Public Policy.

3. Realising the vision

As budget cuts loom, we believe that there has never been a more pressing need to develop an effective social economy. A more innovative, entrepreneurial and sustainable social economy will build society's resilience and enable it to cope better with changes caused by the downturn, new technology and globalisation.

In the previous chapter, we outlined the key features of a new social economy. Once such an economy has emerged one can imagine how it would sustain itself and grow:

- Sustained investment in social impact would demonstrate and prove effective models of social service delivery;
- An established track record of investments in social impact would open-up the market to a wider range of investors, substantially increasing the funding available for addressing social issues and enabling retail investment products, like pension funds and ISAs, with a social twist to become commonplace; and
- Those seeking to work for the benefit of society would have a broad and varied sector to join within which a successful career could be mapped out.

While the role that Social Impact Bonds could play in creating a new social economy is clear, a number of questions remain around the feasibility of implementing Social Impact Bonds on anything like the scale that would be necessary to have a significant effect on the social economy in the UK.

We know that measuring outcomes is hard and identifying cashable public sector savings can be difficult. The scale-up of successful pilots could be challenging – high quality staff and service providers would need to be found.

As we outline in the Section 2 of this paper, careful research would need to be undertaken before Social Impact Bond contracts were used around new social issues. However, as pilots prove to be successful, programmes could be developed elsewhere. These should be considerably quicker and simpler to set-up than the initial pilots.

Realisation of the potential of Social Impact Bond contracts is dependent on the active engagement and support of a range of stakeholders including the public sector, socially-motivated investors and social service providers.

The key questions are:

- How do we get from here to there?
- Who will invest when there isn't a track record? and
- How will we develop outcomes contracts if outcome measures and evidence around effective interventions are weak?

In this chapter, we outline our recommendations around practical steps that government and socially-motivated investors can take to facilitate both the development of Social Impact Bonds and the broader migration to a new social economy in the UK.

Government

In the early stages of developing any new market, incentives are needed to encourage investors and to support the development of market infrastructure, the burden of which would otherwise swamp early initiatives.

We make the following recommendations to Government, in order to stimulate the use of Social Impact Bonds and the development of a more effective social economy.

Appropriate tax treatment of Social Impact Bond outcome payments

To ensure rational decision-making around the value for money case for Social Impact Bonds, we recommend that Government specifies Social Impact Bond success payments[19] as tax exempt.

Without tax exempt status, the public sector would need to compare the value for money of direct payment for services (which has no tax implication) with that of payment through Social Impact Bonds (in which public sector outcome

[19] The payments received by investors for successfully achieving the social outcome.

payments would have to be high enough to offer investors an attractive return after tax). This could artificially skew the public sector decision around whether Social Impact Bonds represent good value for money, preventing their use to generate public sector savings.

Clarifying the tax treatment of Social Impact Bond outcome payments in this way would also send a strong message of support from the Treasury for this initiative, acting as a signal to spending departments that they should be considering these structures.

Tax incentives for Social Impact Bond investment

Given the tax incentives available to support investment in early stage enterprises in the UK, such as Venture Capital Trusts (VCTs) and the Enterprise Investment Scheme (EIS), it would be consistent for similar tax incentives to exist for investment in Social Impact Bonds and other social investments.

While some social investments qualify for VCT and EIS support, many do not, either due to the legal form of the investee organisation or their area of focus. Support from tax incentives for Social Impact Bonds would have a particular rationale, given that the structure is designed to enable savings to the public purse.

Given their expertise and engagement with social impact, providing an incentive to charitable trusts and foundations to invest could also bring a significant pool of capital to bear to develop the market. Furthermore, any returns they made would eventually be used for the public good via their support for other charitable endeavours.

We therefore recommend that Government:

- Mirrors the present support for investment into early stage, small and medium-sized businesses for social investment;
- Provides a tax rebate or similar incentive to charitable trusts and foundations for investing in Social Impact Bonds; and
- Provides, in the future, similar incentives for investment into Social Impact Bonds by retail investors.

Greater local control over public sector savings

Public sector budget holders will be more interested in using Social Impact Bonds if they can see tangible benefits for their department. A decline in re-offending, for instance, should lighten the workload of the police, courts, prisons and probation service. If budgets stay the same, these services will have some spare capacity. They could use this slack to improve the quality of what they do and to fund new initiatives.

However, if local savings are clawed back to a central department or Treasury, the budgets of those involved at a local level would fall, undermining their ability to repay investors from their savings and weakening their interest in contracting for a Social Impact Bond.

We believe that granting greater local control over public sector savings could be important to ensuring local public sector interest in Social Impact Bond contracts.

Creation of an early stage Social Impact Bond fund

A central government fund dedicated to piloting Social Impact Bonds could accelerate the adoption of Social Impact Bonds.

Such a fund could be used to pay a proportion of the success payments for Social Impact Bond pilots when departments are uncertain about whether the social outcome will lead to realisable cost savings. Government might also see benefits to using such a fund to provide part of the success payment where interventions are likely to produce significant savings, but these are spread over several public sector budgets and are therefore hard to coordinate and release.

Finally, the fund could potentially be used to absorb some of the fixed regulatory costs of establishing a Social Impact Bond where pilots are small and such costs could undermine the financial viability at a local level. Alternatively, government could seek to ensure that the regulatory costs involved with social investments are not prohibitive when the investment is small-scale.

Clarification of Charity Commission guidelines around social investment

The Charity Commission guidance on social investment is neither clear nor clearly supportive. This prevents many trustees of charitable trusts and

foundations from considering social investment as a way to supplement the social impact generated from their grant-making activities.

We recommend that the guidance is reconsidered and made unequivocal with examples of good practice and procedures, and guidelines for trustees to follow.

Capitalisation of a Social Investment Wholesale Bank

The creation of a Social Investment Bank, as conceived by the Commission on Unclaimed Assets,[20] is key to the development of the social economy. Such an institution, with a capital base of £250 million or more, and a focus on building the UK social investment market, could:

- Stimulate non-government investment in the social economy by providing capital on the same terms;
- Increase the pool of investors open to considering social investment by stimulating the development of new and existing social investment advisors; and
- Make social investment easier for potential investors to evaluate by supporting the creation of independent research organisations producing high quality, independent research and analysis on the value of social investment opportunities.

Socially-motivated investors

Initial Social Impact Bonds, and those in an entirely new field, are unlikely to be able to raise significant levels of investment without strong participation from investors who are motivated by the opportunity to improve the social issue being addressed.

We are keen to hear from potential socially-motivated investors, whether charitable trusts and foundations, High Net Worth Individuals, or others interested in the strategic development of the social economy and Social Impact Bonds. We believe that such socially-motivated investors have a central role to play in catalysing a new social economy.

[20] *Social Investment Bank: Its organisation and role in driving the development of the third sector.* Commission on Unclaimed Assets, 2007.

Over time, if sufficient Social Impact Bond contracts were in place to justify the creation of one or more funds of funds this could significantly improve the flows of investment into social problems by enabling investors to diversify their risk and sell as well as buy shares in the fund. As dividends could be paid annually, based on success payments from all the programmes in which the fund had invested, such a fund may make it possible to raise capital for interventions that are unlikely to generate public savings for a 10 year period or longer.[21]

Within a mature Social Impact Bond market, the amount of socially-focused money from commercially-motivated investors could come to dwarf that available from socially-motivated investors.

In the early days, trusts and foundations may choose to complement their investments with grants to support research and development around what works to achieve social outcomes. Funding such research for service delivery organisations could increase their likelihood of securing Social Impact Bond funding. Funding research around Social Impact Bond pilots could speed-up the development of an evidence base for social interventions and build understanding around the impact of Social Impact Bonds on social outcomes other than those being targeted directly.

[21] For instance, early childhood interventions with children thought to be at high risk of school exclusions, teenage pregnancy and crime later in life.

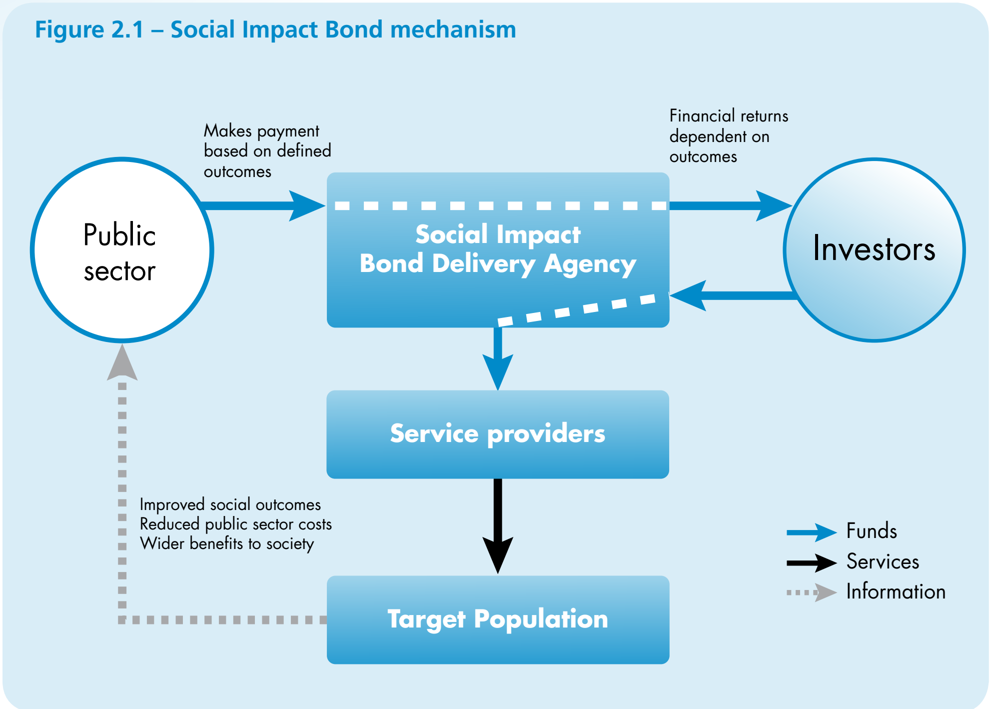
SECTION 2

Blended value creation through Social Impact Bonds

Implementing Social Impact Bonds

Social Finance has developed the Social Impact Bond model and the first phase of pilots in the UK. A summary of the model is outlined in Figure 2.1.

Figure 2.1 – Social Impact Bond mechanism



Our experience of developing these initial pilots has led us to believe that there are three distinct stages to ensuring the successful implementation of Social Impact Bonds to improve social outcomes:

Stage 1 – Feasibility

- Identifying and defining an appropriate outcome;
- Identifying appropriate interventions and the availability of potential service providers;
- Analysing potential returns to investors.

Stage 2 – Preparation for implementation

- Developing a robust contract between public sector agencies and the Social Impact Bond Delivery Agency;
- Raising investment into the Social Impact Bond.

Stage 3 – Delivering outcomes

- Identifying appropriate social service providers;
- Monitoring and flexing interventions through the intervention period;
- Ensuring ongoing impact.

Stage 1 – Feasibility

Identifying and defining an appropriate outcome

The outcome metric forms the foundation of the Social Impact Bond contract between the public sector and investors. All stakeholders need to trust that there is an objective mechanism for assessing and agreeing the degree to which social outcomes have been achieved. Whether or not a suitable metric can be identified is therefore a key determinant of whether or not a Social Impact Bond is the appropriate instrument for addressing an identified social need.

The selected outcome for a Social Impact Bond must be tied to both a change that society values (such as reduced re-offending among short-sentence prisoners) and a direct cost to the public sector (e.g. sentencing and prison costs resulting from reconviction). This ensures that, as the Social Impact Bond delivers an improvement in the outcome, public sector bodies will accrue cost savings, a proportion of which can be used to repay and provide a return to investors.

In addition, an effective outcome metric needs a baseline or control group against which the impact of Social Impact Bond interventions can be measured. The definition of a baseline or control group is most easily achieved if the outcome metric is one for which data is already collected by public sector agencies – for instance the number of convictions by re-offenders. Use of an existing metric also helps to keep costs manageable – establishing new systems for data collection can be expensive.

Care should be taken to ensure that the selected metric does not create perverse incentives. For example, a focus on reducing school exclusions could be achieved by encouraging schools to change their exclusion policies, rather than by addressing the underlying behavioural and social issues.

Perverse incentives could be avoided through the inclusion of ethical safeguards around interventions in the Social Impact Bond contract, or by contracting around more than one outcome measure. A Social Impact Bond

focused on reducing school exclusions might therefore be measured against both reductions in school exclusions and reductions in correlated behaviours like truancy or poor grades.

In identifying an appropriate outcome metric, it is also necessary to consider the most appropriate definition of the target population for whom the outcome will be measured. The target population must be both easily identifiable and accessible for intervention – for instance, offenders released from a particular prison having served a sentence of less than 12 months during the Social Impact Bond period. Accurate definition of the target population is key to the success of Social Impact Bonds. If the definition is not focused enough the interventions may be too diffuse to have a significant impact on the target outcome. If the definition is too focused, the target population may be too small to demonstrate a statistically significant effect. A wider population definition can be used if criteria for identifying the individuals that would benefit most from the interventions are understood. It is prudent to avoid definitions of the target population on the basis of government groupings (e.g. NEETs[22] or participants in PPO[23] programmes) as these definitions may change over the term of the Social Impact Bond.

Finally, given the complexity of setting-up a Social Impact Bond, the target outcome and population need to be priority areas for both policy makers and potential investors. Genuine engagement and partnership increase the likelihood of success.

Identifying appropriate interventions

Having identified an appropriate outcome metric and target group it is then necessary to establish whether preventative work has the potential to improve the target outcome significantly. This is dependent on two considerations. The first is the degree to which interventions that improve outcomes for the target group are understood and evidenced.

22 Young people (16–18 year olds) not in education, employment or training (NEET).

23 Prolific and Other Priority Offenders (PPO). It is estimated that approximately 10% of the active offender population are responsible for half of all crime and that a very small proportion of offenders (0.5%) are responsible for one in ten offences. The PPO strategy provides end-to-end management of this group of offenders.

The second is whether there are already sufficient programmes focused on this group that Social Impact Bond investment is unlikely to lead to significant further change. Further investment in areas where the outcome is being successfully targeted may yield lower social returns and could make it difficult to attribute any improvements to the Social Impact Bond.

Analysing potential returns to investors

Social Impact Bonds are not always the right mechanism for raising finance to tackle social problems. A critical determinant of whether a Social Impact Bond is the appropriate vehicle for funding interventions to address a particular social issue is whether reasonable assumptions about the target population, likely cost of interventions and potential public sector savings generate an attractive financial return for Social Impact Bond investors in light of any investment risks.

There are five key drivers of whether the financial model works:

- The financial value of improvements in the outcome;
- The likely costs of interventions to improve the outcome;
- The expected improvement in the outcome resulting from the investment;
- The share of public sector savings returned to investors; and
- The timing of investment and success payment cash flows.

We examine each point in turn below.

The financial value of improvements in the outcome

The value of the Social Impact Bond outcome is the average public sector cost saving resulting from an improvement in the outcome (this could be per percentage point improvement, or per individual, for instance, prevented from re-offending).

It should be noted that, for the purposes of analysing the potential returns to investors, the outcome value is narrowly defined in terms of the cost savings accruing to specific public sector budgets (e.g. PCT hospital costs, Local Authority social care costs, etc. in a given location). Quantification of broader social benefits (like improved quality of life), as in classic cost-benefit analyses,

reflect important social benefits, but do not release cash from public sector budgets that could be used to make success-based payments to investors.

The strength of the Social Impact Bond model is that it delivers financial benefits to all parties (society, investors, service providers and public sector bodies). Without a financial, as well as social, incentive the model will gain limited traction in the current fiscal environment. Over time, we would expect the broader social value of potential outcomes to play a greater role in determining whether a Social Impact Bond approach is appropriate.

The outcome value is a probability-weighted average of the current cost of a poor outcome to the public sector. The probability-weighted cost is the likelihood of a negative outcome multiplied by the cost of that negative outcome. If the cost of a negative outcome were high, but the probability very low, the probability-weighted cost would also be low.

An illustrative example of such a probability-weighted outcome calculation is outlined in Figure 2.2. This example looks at the average public sector cost of reconviction for an individual leaving prison.

Figure 2.2 – Illustrative probability-weighted cost calculation for the reconviction of a short-sentence prisoner within 1 year of release[24]

	Probability / Cost
The public sector cost of a reconviction within 1 year (in terms of police work, court costs, etc.)	£13,000
Reconviction cost	£13,000
The likelihood of a reconviction leading to a further prison sentence	40%
The costs associated with that further prison sentence	£37,000
Average prison cost	£14,800
The likelihood of a reconviction leading to a community sentence	60%
The costs associated with that community sentence	£6,000
Average community sentence cost	£3,600
AVERAGE COST OF A RECONVICTION WITHIN 1 YEAR	£31,400

[24] The probabilities and costs used in this table are illustrative and do not represent the real cost to the criminal justice system.

The valuation in Figure 2.2 does not include insurance costs, victim costs and the costs borne by society for crime prevention measures.[25] As we outlined above, while these are real costs, a reduction in these costs does not create direct savings in public sector budgets and hence could not be used to make repayments to investors for success.

While Figure 2.2 illustrates the actual public sector savings over one year, improvements in social outcomes will often generate public sector savings over multiple years. For instance, individuals leaving prison after a sentence of 12 months or less often continue to offend over several years following their release. Therefore the outcome valuation should include an estimate of the savings delivered over a longer time horizon, for example the next 3 to 5 years. The right period to consider is a factor of both the need to capture the true value delivered by Social Impact Bond interventions and the need to ensure that payments to investors occur within a reasonable period.

Finally, it should be noted that public sector savings from improved outcomes will almost certainly differ from the probability-weighted cost calculation. There are two potential reasons for this.

The first is the high level of fixed costs involved in the delivery of many public services which means that substantial savings may require adjustments in capacity. For example, in reducing re-offending, there are substantial fixed costs involved with running a prison (e.g. prison staff, heating and lighting, facility maintenance, etc.). These fixed costs will only decrease substantially if the reduction in prisoners is significant enough to close an entire wing or to prevent a new prison being built. Marginal reductions in re-offending would scarcely affect fixed costs. If re-offending drops by 5% in a given area this will not lead to a direct 5% drop in spend on prisons. This may need to be taken into account when agreeing a Social Impact Bond outcome valuation.

The second is the potential for reductions in, for instance, hospital admissions among older people, to simply reduce hospital waiting lists instead of generating free capacity. Such issues need to be carefully considered when

[25] *Reducing re-offending by ex-prisoners* (Social Exclusion Unit, July 2002) quantifies the costs of crime in the UK at £60bn per annum. This takes into account the costs of anticipation of crime (for example, insurance) and the costs as a consequence of crime (for example, health services) in addition to the costs of the criminal justice system.

exploring the feasibility of Social Impact Bond. Establishing the true financial value of improvements in the outcome can be complex.

The likely cost of interventions to improve the outcome

Social Impact Bonds only work when the costs of achieving the target outcome are significantly lower than the size of the resulting public sector savings. It is therefore necessary to undertake an initial scan of local and national service providers at an early stage in order to understand the likely costs involved and to develop an indicative budget for an appropriate mix of interventions.

This budget then determines how much money will need to be raised from investors through the Social Impact Bond.

The expected improvement in the outcome resulting from the investment

A key input into building the financial model for a Social Impact Bond is a reasonable estimate of the improvement in outcomes that can be achieved as a result of the interventions funded from Social Impact Bond investment.

Data to inform reasonable expectations in this area can be hard to find. Sources include:

- Academic literature and other publications that assess the impact of particular interventions on the target outcome; and
- Independent evaluations of the services provided by potential service delivery organisations.

When developing an estimate one must be conscious that data is not necessarily available on a consistent basis. Considerations include:

- Potential differences between the target populations in the research and the Social Impact Bond group in terms of age, life history and geographical context;
- The size of the target population in the research – small samples can lead to results that may not be representative of the larger group; and
- The potential impact of delivering services at a larger scale – for instance, increasing the number of people receiving an intervention could reduce an intervention's effectiveness, or alternatively generate economies of scale.

It may be prudent to be conservative when estimating the likely improvement in the outcome resulting from Social Impact Bond investment as this is a key determinant of whether investors receive a financial return. Use of Social Impact Bonds could potentially lead to a substantially strengthened evidence base around areas of application.

The timing of investment and success payment cash flows

Three key factors influence the timing of the investment and success payment cash flows:

- The intervention period and costs;
- The time lag between the intervention and the measurement of any change in the outcome; and
- The time lag between improvement in outcomes and the release of savings within public sector budgets.

For example, a Social Impact Bond may be developed to fund interventions for prison leavers over a 6 year period. Investors may pay into the Social Impact Bond fund in equal instalments over the first few years. Changes in the outcome measure may be assessed after 1 year and the resulting public savings may take a further year to materialise.

The timing of investor cash flows is a critical input to the financial model. Simplistically speaking, a pound today is worth more to investors than a pound tomorrow. Therefore, the longer investors have to wait for a repayment the greater that payment has to be.

The share of public sector savings returned to investors

Once there is a clear sense of the outcome value, the likely cost of interventions, the expected improvement in the outcome and the timing of investor cash flows, it is possible to establish the percentage of public sector savings that would need to be returned to investors per outcome to generate an attractive financial return for investors.

The attractiveness of the financial return to investors is dependent on the perceived risk of the investment. This is a factor of both investor confidence and the anticipated timing of investor cash flows.

The Social Impact Bond model only works if it delivers benefits to all parties. The cost savings need to be shared between government and investors such that both have an incentive for the Social Impact Bond to succeed. In early Social Impact Bonds, there may be considerable uncertainty about which interventions work, how significantly the outcome could be improved and the cashability of savings to the public purse. Social Finance has therefore worked to bring together public sector agencies and early investors, who see the potential in the model, to deliver pilot projects that will create the knowledge base and track record for Social Impact Bonds to appeal to a wider range of stakeholders.

Stage 2 – Preparation for implementation

Developing a robust contract between the public sector and the Social Impact Bond Delivery Agency

The Social Impact Bond Delivery Agency (SIBDA) represents the interests of Social Impact Bond investors. Among its roles in the early stages of developing a Social Impact Bond is the negotiation of the terms of the contract with the public sector.

The public sector body (or bodies) that enter into the Social Impact Bond contract are those that stand to save most from improvements in the outcome. In the case of a Social Impact Bond targeting a reduction in hospital admissions for fractures among older people, for example, the Primary Care Trust would stand to benefit from reduced health care costs and the Local Authority would stand to benefit from a reduction in admissions to residential care services. They would therefore both enter into the contract with the SIBDA.

By contracting with investors (via the SIBDA, as a coordinating and performance management entity) the public sector ensures that investors are incentivised to identify, evaluate and innovate over the course of the Social Impact Bond to ensure the most effective set of interventions and service providers are deployed to meet local need.

The Social Impact Bond contract should be defined around the outcome rather than interventions. Investors bear the risk that funded interventions will achieve the desired outcomes. Public sector bodies should therefore seek to set appropriate parameters and safeguards to ensure the quality of service provision rather than to define the interventions. Public sector bodies should also seek to ensure that mechanisms are in place for managing the critical interfaces between services funded by the Social Impact Bond and existing publicly-funded services.

The contract between public sector bodies and the Social Impact Bond Delivery Agency sets the amount the public sector will pay for a given change in the outcome, measured in comparison to the baseline or control group. This value is negotiated around many of the key components of the financial model as outlined in the previous chapter, including:

- The financial value of improvements to the outcome; and
- The share of public sector savings returned to investors.

The contract should also cover:

- The measurement and auditing of outcomes; and
- The success payment schedule.

These are explored in more detail below.

Measurement of outcomes

Within a Social Impact Bond contract, the extent to which outcomes have improved determines the level of success payments that are made by the public sector to investors. All parties must therefore be comfortable that the measurement methodology is objective, transparent and independently verifiable.

Within the Social Impact Bond contract it is important to define:

- *The outcome metric and target population* – For example, the outcome metric may be a reduction in acute hospital admissions for fractures among over 65 year olds in a particular region. Both the contracting public sector agencies and investors will take the risk that the outcome metric adequately captures what they are aiming to achieve.
- *The timing and methodology for outcome measurement and measurement audit* – This must be clearly defined within the contract and not subject to retrospective reinterpretation. As the outcome forms the basis for payment, it may also be necessary to stipulate an audit of the measurement process by an independent third party by whose analysis both investors and public sector bodies agree to abide.

- *The baseline or control group against which the outcome will be evaluated* – This is used to determine how much of any change to the target outcome was due to Social Impact Bond interventions rather than background factors. For example if the re-offending rate of the Social Impact Bond population dropped by 5% but there was a national drop of 2%, Social Impact Bond investors should only be rewarded for the additional 3% impact made by their funding. Baselines could be established using a range of measures including randomised controlled trials, matched control groups or proxy control groups.

- *Thresholds for the statistical significance of changes in the outcome measure* – If the change in the outcome measure is too small it may not be possible to attribute the change to anything other than normal variation. The contract may therefore need to include a minimum threshold for change above which a comfortable level of statistical significance can be implied. Statistical significance is driven by the size of the target population and the probability of a negative outcome. All else being equal a larger target population will lead to a smaller threshold requirement.

Success payment mechanism

The Social Impact Bond contract also needs to specify the payment mechanism. This should be constructed to ensure that there are no perverse incentives to "cherry pick" individuals within the target group and only work with those most likely to succeed.

For example, within a Social Impact Bond focused on reducing unemployment it may be cheaper to work with those who have been out of work for a shorter period of time and are therefore most likely to find a job. However, there might be a greater value to society and the public sector from targeting the long-term unemployed.

The payment mechanism could be adapted to address this by increasing success payments to investors as the reduction in unemployment increases. This could incentivise investors to work with the entire target population. Similarly, success payments could vary for different target populations – for example, the payment per outcome could vary according to the length of time someone has been out of work.

Models may emerge in which each individual in the target cohort has a defined value based on a series of objective risk factors. By using the data from previous Social Impact Bonds the model and values could be refined further over time.

Raising investment into the Social Impact Bond fund

Social Impact Bonds offer investors the opportunity to achieve both social and financial returns. Returns are not guaranteed, so investors take on an equity-like risk over a defined period of time. Successful investment in interventions that improve outcomes should generate a healthy financial as well as social return for investors.

To successfully implement a Social Impact Bond, it must be possible to raise investment against the Social Impact Bond contract. In our view, success in raising investment will depend on three factors:

- Investor confidence in the Social Impact Bond contract;
- Investor confidence in the Social Impact Bond Delivery Agency; and
- The maturity of the Social Impact Bond investment market.

Investor confidence in the Social Impact Bond contract

Investor confidence in the Social Impact Bond contract is a function of factors that we have already explored in this section including:

- *Objectivity of the outcome measure* – Investors must have a good level of confidence that any improvement in outcomes due to Social Impact Bond investment will be recognised in an objective, externally verifiable way and rewarded appropriately. Investors will require a good level of confidence around the selected outcome metric in terms of definition, measurement and audit.
- *Pricing of the outcomes-based rewards* – Investors must have confidence that the success payments are set at a level that will enable them to make their capital back plus a moderate return if a realistic level of success is achieved.

- *Repayment period* – Investors are likely to be most attracted by Social Impact Bonds that mature within a reasonable period of time – our current estimate is 4–10 years. This is likely to be a particular concern if it is difficult to exit from a Social Impact Bond investment before the end of the investment period. Investors are also unlikely to be attracted by Social Impact Bond investment opportunities in which there is a significant time lapse between the investment and any indication of success. For instance, investment in early years interventions (with 0-5 year olds) that aim to improve educational attainment, teen pregnancy and crime rates in later life may be hard to fund as a standalone Social Impact Bond unless at least part of the success payments are based on shorter-term indicators of success.

Investor confidence in the Social Impact Bond Delivery Agency

Investor confidence in the Social Impact Bond Delivery Agency as a vehicle for achieving Social Impact Bond outcomes is likely to be determined by four factors:

- *The existence of an evidence base linking interventions to an improvement in the outcome measure for the target population* – Investors will want reassurance that the means of achieving the target outcome are well-understood, properly costed and delivery organisations with a track record of success have been selected in the target locations.

- *The governance and monitoring systems of the Social Impact Bond Delivery Agency* – The Social Impact Bond Delivery Agency needs to demonstrate that it is singularly focused on improving outcomes for the target group. As public sector bodies are likely to be subject to political priorities and accountable for a broader range of outcome measures, investors will require the Social Impact Bond Delivery Agency to be independent of government with a strong, engaged board with relevant expertise. This includes expertise in the social policy area in addition to financial and legal competencies. Board members would ideally include Social Impact Bond investors, particularly those from trusts and foundations that have experience of funding and evaluating work with the target group.

- *The leadership and local partnerships of the Social Impact Bond Delivery Agency* – As coordination, cooperation and alignment with a wide range of existing third and public sector partners is critical to the success of the Social Impact Bond, investors will want reassurance that SIBDA management has a good understanding of existing services and a strong network of partnership relationships in the implementation area.

- *A proven track record of delivery* – Social Impact Bond Delivery Agencies with a track record of delivering Social Impact Bond returns will almost certainly find it easier to raise investment. In initial pilots, where none such exists, investors will seek to ensure organisations and individuals with relevant policy, management and delivery experience are represented within the Social Impact Bond Delivery Agency executive and board.

In the initial pilots, the role of Social Impact Bond Delivery Agency will be played by a subsidiary of Social Finance. As Social Impact Bond contracts become more common we anticipate the development of a competitive market of Social Impact Bond Delivery Agencies. For the Social Impact Bond market to scale it will be critical to develop and build the capacity and expertise of such Social Impact Bond Delivery Agencies.

The maturity of the Social Impact Bond investment market

The final determinant in raising investment for Social Impact Bonds is the maturity of the Social Impact Bond market itself. Investment is most likely to be available at scale if:

- The Social Impact Bond mechanism has an established track record of delivering social and financial returns;

- There are appropriate opportunities to invest at scale;

- Investments can be traded and hence sold before the end of the Social Impact Bond period (market liquidity); and

- Investors could spread the risk of their investment by investing in multiple Social Impact Bonds simultaneously (through a fund of funds or similar mechanism).

In the initial phase of Social Impact Bond roll-out, while the market is immature, we believe that the majority of Social Impact Bond investors will be socially-motivated investors that have an interest in improving the target outcome. Investing in these areas of social need will supplement existing grant-making. Over time, as a track record develops, capital will be unlocked at scale only if retail and institutional investors can be attracted to invest.

The engagement of trusts and foundations in this work is also helpful in terms of validating the social impact for more financially-minded investors.

Stage 3 – Delivering outcomes

Identifying appropriate social service providers

The diversity of British society means that drawing-up detailed social service delivery specifications at a national level can be fraught with difficulty. Individuals and their contexts vary so widely that tailored interventions are often best developed at a local level, where local cultures, needs and circumstances can be taken into account. The Social Impact Bond contract with government specifies the desired outcome, but not the means of achieving it. This means that interventions can be tailored to local needs and can evolve over time as needs change.

The Social Impact Bond Delivery Agency will be responsible for working with local partners to identify interventions and service providers that have a track record of improving the selected outcome and addressing the needs of the target population. The Delivery Agency will source a basket of programmes that tackle the root causes of the social issue.

To do this effectively, the Social Impact Bond Delivery Agency needs a good understanding of the local stakeholders currently working with the population. To reduce re-offending this would include the police, probation and prison service as well as other agencies such as the Local Authority.

To ensure that the operations of the Social Impact Bond are aligned with investors' interests, service providers and staff might receive incentive payments linked to investor returns, in addition to up front payments for service delivery.

Monitoring and flexing interventions through the Social Impact Bond period

The ability to learn and develop service provision in line with experience is critical to the success of this model. We envisage that Social Impact Bond Delivery Agencies will collate data and performance information using a common platform across the set of funded interventions. This will allow a

rich data set to develop informing a greater understanding of both the value of different interventions to different sub-sets of the target population, and of how interventions work together.

During the term of the Social Impact Bond, interventions will evolve as the most effective programmes are identified and built upon, allowing a gradual progression towards an evidence-based mix of successful interventions. Additional services will also be built-in over time as specific local needs are identified.

Ensuring Ongoing Impact

As, by definition, Social Impact Bonds only fund interventions for a fixed period of time, thought must be given to how to maintain the positive impact of a Social Impact Bond at the end of the intervention period.

In our view, there are two options for government at the end of a Social Impact Bond contract:

i. Government might decide that the programme had been so worthwhile that it would now fund the interventions itself. It might supervise this spending directly, ask the independent Social Impact Bond board (which would have expertise and an existing set of relations) to do so on its behalf, or invite the Social Impact Bond board – along with others – to tender for this new contract.

ii. Government might invite the Social Impact Bond board (perhaps following a competitive tender) to raise another Social Impact Bond on the basis of a new set of outcome targets. This would be an opportunity to update the metrics if better measurement methods had been developed and to incorporate learning from the life of the Social Impact Bond.

From a public sector perspective, these approaches have different strengths. The first enables government to use savings over the course of the Social Impact Bond to take advantage of the potential cost efficiencies from commissioning services directly.

The second enables government to continue to transfer the risk of intervention failure to investors, and retains both the mechanisms and incentives for the continuing adaptation and improvement of services.

In practice government may choose to do both – using public funds to pay for services to maintain the improvement in outcomes that has been achieved and raising a second Social Impact Bond to fund further or related improvements.

APPENDICES

Appendix 1 – Preconditions for a successful Social Impact Bond

Preconditions for a successful Social Impact Bond	
Robust outcome metric	• The outcome metric is the foundation of the contract between public sector agencies and investors. • All stakeholders need to trust that there is an objective mechanism for assessing and agreeing the degree to which outcomes have been achieved. • Ideally, an existing metric as this minimises measurement costs and maximises the potential for controls and clearly defined, appropriate baselines.
Clearly defined target group	• A target population must be both identifiable and accessible for intervention. • Must be large enough for a statistically significant effect but targeted enough to ensure that interventions are focused on maximum need.
Evidence-based interventions	• Investors must have confidence that interventions to achieve the target outcome are well understood. • It must be possible to estimate the impact of a certain level of investment on the target outcome.
Cost of intervention is smaller than public sector savings within the Social Impact Bond period	• Public sector savings must be significantly larger than the costs of interventions to achieve the outcome. • Public sector savings must be cashable within the Social Impact Bond period. • Ideally, the majority of savings accrue to one or two public sector agencies.
Issue area a priority for public sector	• Multiple stakeholder partnership and engagement is needed for success.
Issue area a priority for investors	• Currently the Social Impact Bond is in a pilot phase and has not yet developed a track record as a financial product. • Investors at this stage need to be engaged with the social outcome being targeted and not just the financial return.

Appendix 2 – Why use Social Impact Bonds?

The table below compares the benefits of using Social Impact Bonds to fund services to improve social outcomes against those of outcomes-based contracts and government debt.

	Social Impact Bonds	Outcomes-based contracts	Government debt
Public sector only pays for success	✓	✓	✗
Risk that interventions do not improve outcomes is transferred away from the public sector	✓	✓	✗
Additional non-government finance is provided to improve social outcomes	✓	✗	✓
Public sector payments are proportional to the improvement in social outcomes	✓	?	✗
Service providers' costs are funded up front	✓	✗	✓
Facilitates cooperation between multiple service providers	✓	?	✗

As we explore in the body of the document, standard outcomes-based contracts are agreed between the public sector and service delivery organisations. They require service providers to cover the up front costs of service delivery and hence tend to favour larger, better-funded organisations with access to reserves or loans.

Government debt is raised from investors through the issuance of gilts offering a fixed term and fixed return to investors. Funding raised in this way can be used to fund any public sector programmes, but does not, in itself, create new incentives to innovate to provide the best services. Debt can most effectively be used when additional funding is required to roll-out interventions with an established track record. Where there is a low risk that interventions fail to achieve the target outcomes, this may be the most cost-effective way to fund these programmes.

A Social Impact Bond is a contract in which the public sector commits to pay for improved social outcomes. On the back of this contract, investment is raised from socially-motivated investors. This investment is used to pay for a range of interventions to improve the social outcome. The financial returns investors receive are dependent on the degree to which outcomes improve.

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We believe that the market and society need each other and can work more closely together. We develop structures that enable investors to invest in social progress and receive returns that can be invested in society again. In this way we make more money available, more sustainably, to address entrenched social issues.

To find out more about Social Impact Bonds contact Social Finance on: 020 7667 6370 or info@socialfinance.org.uk

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