White Paper -- Social Impact Bonds

Introduction

As governments, researchers, social service providers, and philanthropists have struggled with what some see as intractable social problems, a critical question has always been how to bring promising social service interventions to scale, and how to finance up-front costs of programs for which fiscal and societal benefits may not be realized for years.

In recent years, a Social Impact Bond, or SIB, has emerged as, a new concept for investing in such government programs. Not technically a bond, a SIB is a performance-based contract that attempts to take the financial risk of failure away from governments and service providers and give it to non-governmental financiers. In some cases, the financing structure includes using future savings resulting from successful interventions to repay the investors.

Interest in Social Impact Bonds has been growing within the District. In February of 2013, Councilmember Alexander introduced the "Social Impact Financing Amendment Act of 2013", which would amend the District's procurement laws to allow for SIBs. In November of 2013, the Mayor's Office of Budget and Finance (MOBF) engaged a firm to develop a feasibility study to assist the District in determining the most appropriate content area to initiate a SIB project. The results of this study will be available in Spring of 2104. As discussed later in this paper, there are three essential questions in any decision by the District to enter into a SIB agreement. 1) Is the SIB likely to save the District money? 2) Are the costs and risks allocated fairly, and 3) How should the District budget for payments agreed to now, but paid out into the future?

This paper will provide detail on how a SIB works, including the allocation of costs, risks and responsibilities. It will then provide an example of this allocation using the first SIB in the US and will briefly discuss other state and Federal initiatives including performance-based contracts that are similar to SIBs. Finally it identifies questions that should be considered before launching a SIB in the District.

<u>What is a Social Impact Bond?</u>

A Social Impact Bond (SIB) is not technically a bond, it is an investment vehicle designed to encourage private funding for promising social programs, with a goal to grow "evidence-based" interventions. SIBs are a specific kind of "Pay-for-Success" (PFS) contract. A PFS contract is a performance-based contracting mechanism in which government pays a service provider after it achieves predefined *outcomes*, rather than for *outputs*. For example, a social service provider offers after-school programs for low-income children with the goal of reducing remedial education costs in the future. Instead of being reimbursed at a rate per child, the provider might be paid based on an evaluation of how many children needed remedial services in future years. These types of contracts are typically used to improve social outcomes for individuals (i.e. former prisoners, low-income children, and high school dropouts) that have corresponding long-term fiscal savings for governments (such as higher income and sales taxes and lower public costs for healthcare, child care, subsidized housing, and incarceration).

For traditional PFS contracts, the financial risk, if outcomes are not achieved, is taken by the service provider. SIBs shift this risk to private investors, who bring in the capital for the service provider to fund its services. Many believe that by bringing in the capital markets and private sector discipline, SIB programs are more likely to go to scale. (Another type of bond offered in Minnesota, the Human Capital Bond, discussed below, combines bond financing with PFS contracts, but leaves the financial risk at the service provider level.)

As stated above, Social Impact Bonds are meant to bring to scale government-supported social programs by utilizing private sector investment. Often, these programs have some proven success on a small scale, and the goal of the SIB is to expand the program to a bigger scale. A SIB is not a bond in the traditional sense, rather, it is a type of performance-based contract in which:

- A service provider provides a social service or "intervention";
- Private investors pay the costs of the service provider;
- The public sector commits to making payments for the services at a later date, but only if the social outcomes are achieved;
- The payments are structured to include the cost of the intervention as well as some interest (or "return") for the investors;
- A third-party evaluation confirms whether the outcomes have been achieved, at which point the public sector will repay the investors.

Achieving the social outcome is usually expected to reduce government costs, often in other program areas, when the outcome is achieved. *Therefore, in the long run, the costs of repaying the investors may not be additive to the government's budget*

Specifically, the benefits of SIBs include:

- Governments are able to preserve public resources for successful interventions while still encouraging innovation, particularly in a time of fiscal constraints. [1]

- Nonprofit service providers receive a committed funding stream not subject to budget cuts.

- Private investors, (which can include philanthropic foundations) can receive financial returns for assuming the financial risk, in addition to achieving a public good.

- Individuals receiving the service provided may experience better life outcomes areas such as of education, employment, and independence.

Social Impact Bonds in the U.S.

A variety of SIBs have been structured to address youth prison recidivism, poor outcomes for low-income teens, and chronic homelessness. While SIBs were first tested in England beginning in 2010, the first U.S. SIBs were launched in 2013. The first is attempting to address adolescent incarceration in New York City and is detailed below. The few others that have been launched since that time have financing structures that are almost identical. Depending on the outcomes that are anticipated, the evaluation and repayment time can vary greatly.

[1] Rikers Island: The First Social Impact Bond in the United States", John Olson and Adrea Phillips, Community Development Investment Review, Volume 9 Issue 1, 2013.

Example: New York City/Rikers Island Jail

In New York City, nearly 50% of 16- to 18-year-olds who leave the Rikers Island Jail return within one year. A SIB program was initiated with the goal of decreasing future criminal behavior and re-incarceration. The main attributes of the program are:

- A therapeutic interventions program "Adolescent Behavioral Learning Experience"[2] is provided to 16-18 year olds in Department of Corrections (DOC) custody, both during their detainment at Rikers Island Jail and after release, in the community.
- The goal is to improve social decision-making, problem solving and self-control skills management.
- To the extent practicable, all adolescents (approximately 3,000 per year) will be served over a 4-yearperiod.

The SIB Contract is very complex and includes many parties:

- **MDRC** oversees the day-to-day implementation of the project. MDRC is a national social policy research intermediary that brings together public and private funders to test new policy-relevant ideas;
- **Osborne Association** and **Friends of Island Academy** are the two non-profit service providers that deliver the intervention;
- **Goldman Sachs** is the investor who provides MDRC funding for the project's delivery and operations with a $9.6 million investment to **MDRC** ($2.4 million per year for four years);
- **The Vera Institute of Justice**, an independent evaluator, determines whether the project achieves the targeted reductions in reincarceration;
- **The Department of Corrections** contracts to pay MDRC based on reduced re-admissions and the associated cost savings. MDRC would use such funds to re- pay its loan from Goldman Sachs.
- **Bloomberg Philanthropies** pledges $7.2 million to guarantee a portion of Goldman Sach's investment (only paid if MDRC does not meet its targets)

The repayment to Goldman Sachs is tiered based on performance. For example:

- A 10% recidivism reduction is the breakeven point for the investor, and results in a $9.6 million repayment by the City. – This reduction is projected to generate $10.6 million in long-term savings for the city or $1 million in savings, after the cost of the program.
- A 20% recidivism reduction results in an $11.7 million repayment by the City. – This reduction is projected to generate $20.5 million in long-term savings for the City.
- Under the 10% reduction scenario, the investor will receive a 0% return.

[2] Adolescent Behavioral Learning Experience is a type of Moral Reconation Therapy, a cognitive behavioral program designed to help offenders reevaluate their choices and enhance their decision-making abilities. Those who leave Rikers before completing the program have the opportunity to resume participation afterward when they return to their communities. "The deep experience, expertise, and accomplishments of the partners in the transaction, MDRC and Osborne, grounded Goldman Sachs' confidence that the social outcomes would be achieved. In addition, the review of the efficacy of the proposed intervention uncovered an extensive body of research that shows that the type of therapy that would be provided is effective in significantly reducing recidivism rates." Community Development Investment Review, Volume 9, Issue 1, 2013. p 99.

- Under the 20% reduction scenario, the investor will receive an 8% return.

This Rikers Island SIB example, with a philanthropic foundation partnering to guarantee a portion of the private sector investment, appears to be the standard for completed SIBs in the US. Guarantees have ranged, however, from a high of 75% in the Rikers Island example, to as little as 10%.[3]

<u>Other Initiatives</u>

Fourteen States and the District of Columbia have been active in Social Impact Bonds through legislative or procurement initiatives. Like the District, many are in the process of selecting feasible projects.

Massachusetts

Massachusetts' interest in SIBs stemmed from success in their Housing First program. The program provided housing and services to homeless men, and the success of the program was measured against the resulting savings in Medicaid costs (though there may be other cost savings and benefits). Under the program, annual Medicaid costs per person went from $26,000 to $8,500.[4]

The Massachusetts SIB legislation gives "full faith and credit" status to SIB contracts, allowing the state to pledge revenues in future years and allowing investors to avoid "appropriations risk". In July 2012, Massachusetts authorized $50 million for its Social Innovation Fund to cover its potential obligations in pending PFS transactions. The Massachusetts legislation addresses an issue that the District would have to consider in any decision to enter into a SIB contract: how to pledge today for future outcomes based on future savings? This issue is discussed further below. In January of 2014, Massachusetts launched its first SIB which targets at-risk young men in the probation system or leaving the juvenile justice system, also with the goal of reducing recidivism.

Minnesota

Minnesota has created a new type of bond program that brings in private funds, without shifting the risk of successful program implementation. The Human Capital, or "HUCAP Bond," is based on the success Minnesota had with a 15-year Pay-For-Success contract administered by the Department of Employment Development. In that program, a workforce development nonprofit provided intensive education and training to difficult-to-employ individuals, being paid only when a client is placed in a job earning more than $20,000 per year, and where the change in their income is at least $10,000. Half of the contract payment was paid at job placement, the other half after one year on the job. Based on the State's estimates of higher income and sales taxes and lower public

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[3] "Social Finance Drives Landmark New York State Deal" http://www.socialfinanceus.org/what-we-do/select-current-engagements/social-finance-drives-landmark-new-york-state-deal

[4] Joe Finn and Jeff Hayward, Bringing Success to Scale: Pay for Success and Housing Homeless Individuals in Massachusetts Community Development Investment Review, Volume 9, Issue 1, 2013. p 135

costs for healthcare, child care, subsidized housing, and incarceration, the state maintains that, over the last 15 years, they have benefitted from a return on investment (ROI) of more than 600%.[5]

Following the success of the original program, the Minnesota legislature passed the 2011 Pay for Performance Act which authorized the sale of $10 million in annual appropriation bonds (bonds paid for with an appropriation for debt service, but not full faith and credit) to finance a HUCAP pilot project on the premise that social service providers can create financial value from the social benefit they create. The HUCAP bond is a government bond through which proceeds are set aside to pay the service provider for success. The pilot program includes a new budgeting process whereby the cost of the program is included in the budget as an expenditure of the Department of Employment and Economic Development, but over the 10 years of the bonds, the savings in the Departments of Human Services and Corrections, resulting from fewer clients or prisoners respectively, are accounted for. If the program is successful, the state anticipated the overall agency costs will be lower and there will be excess funds available in the agency budgets.[6] Again, HUCAPs are not SIBs because the social service provider takes the funding risk if the goals are not achieved, rather than an investor. However, they are similar to SIBs in that the government does not make any payments if the social service does not yield projected results. As compared to a SIB, the interest cost of the financing is lower (close to GO rates on the bonds) and any additional payments due to successful interventions can be realized by the service provider rather than a private investor.

The Federal Government

The Obama administration has created a program called the Incentive Fund to support state and local projects that will result in federal savings in programs such as housing and healthcare. The Incentive Fund intends to provide a budget mechanism to pay for outcomes in proportion to the federal share of savings from the Fund. In the FY2014 Budget, President Obama proposed $300 million for the Incentive Fund to allow cities, states and nonprofits to support more public-private partnerships that produce measurable results in their communities. In addition to the Incentive Fund, another $195 million is proposed to support Pay for Success programming in nine programs across three different federal agencies: the Departments of Labor, Justice and Education.

Housed within US Treasury, the Incentive Fund will support PFS approaches with "credit enhancements" to reduce downside liabilities to investors. (This is similar to how the Bloomberg Foundation credit enhanced the Goldman Sachs investors in the New York City example above.) The Incentive Fund will partially offset losses, but only for public and nonprofit investors. The premise is that, in the absence of such backing, investors might demand a rate of return the state and local governments cannot afford, killing the market before it emerges.[7] Due to the budget impasses on Capitol Hill, this initiative has not yet been funded.

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[5] Steve Rothschild, Human Capital Performance Bonds, Community Development Investment Review, Volume 9, Issue 1, 2013. p 104

[6] Ibid p 105

[7] The Promise of Pay for Success, Jonathon Greenblatt & Annie Donovan,, Community Development Investment Review, Volume 9, Issue 1, 2013. p 19

However, other federal programs supporting Pay-For Success include:

- Office of Social Innovation and Civic Participation at the White House
- Social Innovation Fund at the Corporation for National and Community Service
- Investing in Innovation (i3) Fund at the Department of Education
- Workforce Innovation Fund at the Department of Labor
- Second Chance Act – Department of Justice

Investors

Different types of investors may be interested in Social Impact Bonds. They will invariably be "social impact" investors and the interest rate they demand will depend on their own risk calculation (risk-adjusted market rate) as well as their level of social motivations (below-market rate). Investments may take the form of debt, equity, credit enhancement, or a combination of these.

Profit-seeking investors will likely be most interested in social programs that are proven and/or are credit-enhanced with foundation or government backing. The argument for relying on private investors is that (1) they offer the capacity to bring promising social interventions to scale, and (2) they can bring due diligence and discipline to the process of provider selection and delivery of social services. Socially-motivated investors, which include commercial banks looking for CRA credit, will likely invest with below-market returns. This kind of impact investment is different from philanthropy because investors relying on a return of their capital will need to do more due diligence than foundations that have more ability to give money away.

Foundations can invest directly in SIBs or, more commonly, provide a credit enhancement to private investors. Foundations view SIBs as a way to put research to work when evidence supports a program and make their dollars go much further. Foundation funds invested as a guarantee in a SIB provide social benefits and, if successful, have no cost to the foundation. As noted above, the guarantees provided in US SIBs have varied from 10% to 75%. Where such a guarantee falls in this range will depend both on the expected program successes as evidenced by prior research and the understanding by the private investment community of this new investment instrument.

What to Consider in Creating a Social Impact Bond Program

Social Impact Bonds can be used to fund programs a government either has not chosen or been able to finance itself, or programs that are so innovative that the government does not wish to take the risk of funding them prior to them being proven effective.

If there are no short-term budget concerns and little risk of program failure, then creating a SIB does not make sense. While SIBs do allow the government to better align the year-of-expenditure more closely with the year-of-benefits, it would generally cost the government more money not to run a program that saves more money than it costs to run. In other words, policy makers need to make sure SIBs are not just another way to privatize a fundamental government service.

Governments are the ultimate payer in SIB transactions. They still pay for positive outcomes, but only after these outcomes have been demonstrably achieved.

Success depends upon all parties understanding their risks, costs, and trade-offs:

- Potential for measurable social impact
- Setting up and agreeing to solid evaluation criteria prior to contract execution
- Ease of identifying and capturing economic value
- Financial risk and return to each stakeholder
- Reputational risk for each stakeholder
- Transaction execution and due diligence costs
- Cost of capital to the government, service provider, and investor
- Transaction management and governance structures
- Legislative requirements and appropriations risk

A government's role in developing a SIB includes assessing each of these factors. It must balance the costs and risks to the government with the risks of all of the non-governmental partners. From a government's perspective, the critical elements of any SIB are:

- Holding repayment until clear evidence that savings are in fact being achieved increases the government's confidence in the effectiveness of the program.
- Spreading out repayment to align with the value produced by the program increases the government partner's ability to pay.

SIBs are not appropriate for every area of social welfare activity. They are an attempt to change a culture of government funding of the social sector and encourage investment into social challenges that have either been overlooked or not effectively delivered before. SIBs need to have a clearly defined outcome that can be independently measured and attributed to the SIB's investment. Such outcomes could be defined as direct financial savings for the government, but the contracts can also be structured around direct outcomes of the planned intervention, such as lower crime rates, better air quality, or fewer suspensions, which may not have identifiable correlated savings. Complementary improvements that may be difficult to measure, such as wellbeing and community happiness, may be important outcomes but the SIB parties may be reluctant to incorporate assessments of such factors into the contract.

Finally, SIB design requires expertise in incentive contracting, cost-benefit analysis, and evaluation design that may not exist in-house. The complexity of an SIB essentially requires <u>at least</u> 4 parties (investor, service provider, government, and independent evaluator) to come to agreement on expected costs, risks, service provision, timelines, and the value of outcomes. In some SIBs the number of parties can be much greater, including intermediaries, who may negotiate the contract and separately manage the service providers; foundations; and various government agencies. <u>Therefore, a robust SIB program would benefit from a dedicated staff with financial, evaluation, and contracting expertise.</u>

Developing a Social Impact Bond Program in the District

As part of designing a social impact bond program, three additional issues, perhaps unique to the District, must be addressed:

- Impact on the Debt Cap. The long-term contract will create a future payment obligation from the District. Prior to a launch of a SIB, a determination about whether or not a SIB is considered District debt for purposes of the Debt Cap calculation must be made. If these future payments are to be included in the Debt Cap, then the utility of SIBs in the District's current debt environment could be severely limited.
- Impact on the Budget. With or without a formal pledge, a SIB would require budget authority in the year where payment is expected. In other words, the District would have to assume the program will be successful and budget for it with the maximum expected payments. Alternatively, if a SIB is structured to be paid only from savings in other program areas, the District's budgeting rules would most likely require that this "swap" of budgeted funds be authorized annually in advance.
- Adherence to the Procurement Procedures Act. (PPA) All contracts in the District are subject to the PPA, unless specifically exempt. The PPA includes rules relating to competitive bidding and inclusion of certified minority business enterprises, among others. A SIB program would likely require special legislative and budget authority, possibly with specific exemptions from the Procurement Procedures Act (PPA) or other procurement requirements.

The Mayor's Office of Budget and Finance is expecting the results of its Social Impact Bond Feasibility Study in April of 2014. That study is meant to provide a menu of 2-4 possible issue areas, with a rough cost/benefit analysis of each. Before the District makes a decision about what type of SIB it would like to move forward, it should address these three issues. If these issues can be addressed, with the right partners, a SIB program could assist the District in investing in promising new solutions or innovations to long-entrenched social problems.