



Social Impact Bonds

by Lenny Roth

1. Introduction

Social Impact Bonds (SIBs) have been proposed as a new way of funding the not-for-profit sector to deliver social programs. The development of, and interest in, SIBs can be attributed to a number of factors including:

- Recognition that traditional ways of funding the delivery of programs that address complex social problems are struggling to keep up with demand;
- The emergence of social impact investing: a new breed of investors who aim to achieve a blend between commercial value and social impact.¹

In his September 2011 [budget speech](#), the NSW Treasurer, Mike Baird, announced that the NSW Government would be establishing a trial of "Social Benefit Bonds".² On 30 September, the Government released a [Request for Proposal](#) to identify two pilot Social Benefit Bonds in the areas of recidivism and out-of-home care.³

The idea for trialling Social Impact Bonds in Australia was first [raised](#) in November 2010 by the former Premier, Kristina Keneally.⁴ The Keneally Government sought advice

on this proposal from the Centre for Social Impact and, in a February 2011 [report](#), the Centre concluded that the concept was feasible in NSW.⁵

The United Kingdom is the only jurisdiction to have so far proceeded with a trial of a SIB. The Ministry of Justice has entered into a SIB to fund interventions for offenders who are serving short prison sentences at Peterborough prison. This program was [launched](#) in September 2010.⁶

The concept has also recently been taken up in the United States. The 2012 federal [budget](#) allows for up to \$100 million to fund "Pay for Success" Bonds across seven program areas including education, juvenile justice and care of children with disabilities.⁷

2. What are SIBs?

The term "Social Impact Bond" has been applied to two quite different types of funding mechanism.

It has been applied to a funding arrangement where a charity or social enterprise issues bonds to raise capital for a particular social program or area of its operations. The charity or social enterprise agrees to repay investors their principal and a rate of interest.⁸ These SIBs operate in the same way

as corporate bonds but the funds are used for social purposes.

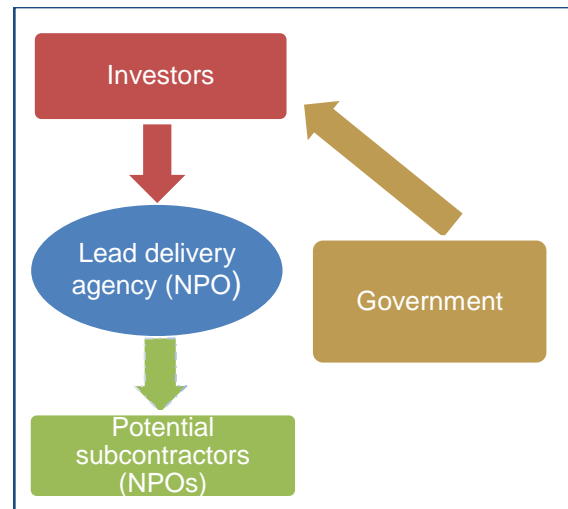
The SIB label has also been used in relation to another arrangement, which is quite different to a traditional bond. This funding mechanism (which is the focus of this e-brief) can be structured in different ways but, in its basic form, involves the following:

- Investors agree to provide up-front funding for a social program targeting a particular group;
- One or more not-for-profit organisations (NPOs) agree to deliver the social program over a certain period of time;
- The Government agrees to repay the initial investment and pay a return if the program achieves the target outcomes (as these lead to public sector cost savings).⁹

The Centre for Social Impact has described SIBs in these terms:

Under a SIB, a bond issuing organisation raises capital from investors based on a contract with government to deliver improved social outcomes that generate future government cost savings. These savings are used to pay investors a reward in addition to the repayment of the principal, if the agreed outcomes are achieved.¹⁰

In one delivery model, the bond issuing organisation that raises capital from investors could be an NPO that will be delivering, or involved in delivering, the social program (see the diagram below¹¹). In another delivery model, a special purpose vehicle could be established to issue bonds to investors and contract with NPOs to deliver the program (see the UK pilot, which is outlined in Section 6).¹²



SIBs can also use different risk sharing structures. One arrangement might be that investors will not receive any payment if the program does not meet the agreed outcomes. In another model, investors might receive partial repayment of their principal if the program does not meet the targets. If there is an intermediary involved, this organisation could also share the risk (and return) with the investors.

According to the Centre for Social Impact, a range of investors might be interested in SIBs including:

- High-net worth individuals;
- Charitable trusts and foundations;
- Private ancillary funds;
- Self-managed super funds;
- Larger super funds;
- Financial institutions.¹³

3. Potential benefits

The NSW Treasury has [referred](#) to the following potential benefits of SIBs:

A focus on outcomes rather than outputs: Under traditional purchaser-provider arrangements, Government payments typically attach to units or blocks of service rather than the outcome the Government is seeking to achieve. In contrast, SIBs provide a direct financial incentive to focus on and improve the

outcome in question. This change benefits both the Government and providers: the Government gets better outcomes, while providers are relieved of burdensome reporting to Government about service inputs and outputs, and instead are free to focus on delivering the outcome in a way that best suits their own approach and preferences.

Additional resources towards early intervention: Releasing Government funds for prevention and early intervention can be difficult when resources are oriented towards acute and crisis services. SBBs allow an expansion of investment in early intervention through the use of upfront private funding. If successful, this reduces later demand for acute services and frees up Government funds, part of which can then be used to repay investors.

Innovation: Payment for results, rather than delivery of a prescribed service, frees service providers and investors to explore different ways of achieving better results. Providers have the flexibility to change service delivery approaches or experiment with a number of approaches at the same time. Investors have an incentive to work with providers to drive performance; for example, by encouraging providers to abandon approaches that are not achieving results and supporting them to find and implement new approaches

Improving the evidence base: SBBs will be more attractive to investors if they are backed by evidence that indicates that the proposed interventions will be successful. Further, the link between payments and results necessitates the robust measurement of outcomes. These features increase locally relevant evidence and data for future policy makers. By improving measurement in these areas, the Government believes that other social policy areas will benefit as well.

Accountability and transparency: The focus on clear outcomes measurement in SBBs ensures that there is clarity about what NSW Government funding is achieving, and when.¹⁴

4. Potential challenges

In a [paper](#) published by the Young Foundation in the UK, Geoff Mulgan et al stated that SIBs face important challenges, of which three stand out:

- The relative weakness of the evidence base (and resulting difficulties facing any investors or banks wanting to judge the risk of a particular set of interventions, and the bodies being funded to carry them out);
- Overlaps with existing public programmes. [SIBs] depend on demonstrating a causal link between additional spending and outcomes achieved. This is hard for target groups already in receipt of public support, such as young people under 18. To solve the problem, either contracts and measurement systems have to become complex – and require other public agencies not to cut or change existing programmes – or some form of partnership agreement is needed which ties in with other public providers;
- Issues of scale and transaction cost. Most [Private Finance Initiatives] under about £25m turned out to be uneconomic due to the high transaction costs. There may be a similar lower limit for SIBs, which is challenging given that any pilots are likely to be on a significantly smaller scale. In addition SIBs face the challenge that also faces all new financing tools around public services, namely that governments always have a significantly lower cost of capital than other bodies.¹⁵

In relation to this last point, they commented that a common response from Treasuries is that SIBs:

are an unnecessarily complex way of financing better social programmes. Since government's costs of capital are significantly cheaper than markets, they should be providing finance. If there really are better approaches to cutting recidivism or unemployment, these should be directly funded by governments, rather than indirectly via SIBs.¹⁶

Conversely, the NSW Treasury has commented that:

...SBBs have an advantage over current direct funding models in that public funds are only expended (in the form of principal and reward payments) after the benefits have been achieved.

Another benefit of the SBB funding model is that, by accessing private capital, it facilitates upfront expenditure over and above what is available from public funds at the time the expenditure is needed. If the funded intervention is successful, additional public funds are then freed up to repay the upfront expenditure.¹⁷

5. Critical success factors

The Young Foundation [paper](#) states that the following factors are likely to be critical to the success of an SIB:

1. **Preventative intervention** – The intervention is preventive in nature and sufficient funding for the intervention is currently unavailable;
2. **Improves wellbeing in an area of high social need** – The intervention improves social wellbeing and prevents or ameliorates a poor outcome;
3. **Evidence of efficacy** - The intervention is supported by evidence of its efficacy and impact, giving funders confidence in the scheme's likely success;
4. **Measureable impact** – Whether it is possible to measure the impact of the intervention accurately enough to give all parties confidence of the intervention's effect, including a sufficiently large sample size, appropriate timescales and impacts that [are] closely related to the savings and relatively easy to measure;
5. **Aligns incentives** - A specific government stakeholder achieves savings or lower costs as a result of actions undertaken by others. These savings need to be cash releasing and provide an actual saving to government stakeholders;

6. **Savings greater than costs** - The savings for the specific government stakeholder are relatively immediate and much greater than the cost of the intervention and transaction costs. This provides investors with enough return to absorb the risks inherent in the scheme, and can provide significant funds for social investment; and

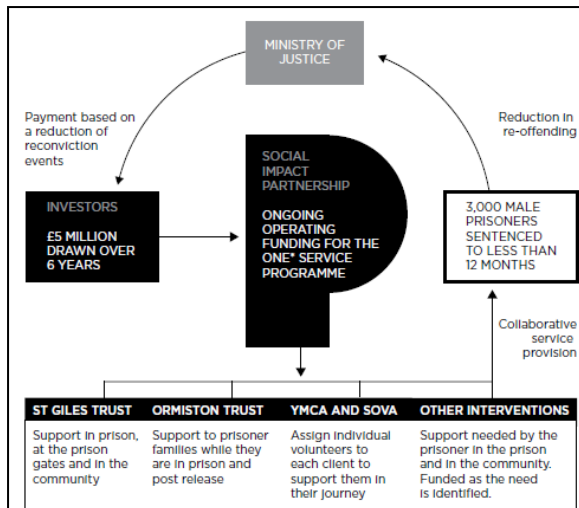
7. **Government preference for a SIB** - Government policy for the specific agenda is keen on or at least open to the use of a SIB.¹⁸

6. United Kingdom pilot

The UK Government entered into a pilot Social Impact Bond in March 2010.¹⁹ It aims to reduce reoffending by prisoners who are serving a sentence of less than one year at Peterborough prison. These prisoners receive little statutory support to address the causes of their offending and 60% of them reoffend within one year of being released from prison.

Social Finance UK, a financial intermediary, obtained £5 million of funding from 17 investors (mainly charities and foundations but also high-net-worth individuals). This fund will pay for interventions for 3,000 prisoners at Peterborough. The program (One* Service) will be provided by non-profit organisations including St Giles Trust, and Ormiston Children and Families Trust.

This SIB involves an intermediary (the Social Impact Partnership), which is a limited partnership that was set up by Social Finance UK to manage the contract and coordinate service delivery on behalf of investors. The Partnership has entered into contracts with investors, the Ministry of Justice, and with the service providers. The SIB structure is shown below.²⁰



The Ministry of Justice and the Big Lottery Fund will make payments to investors but only if reoffending (i.e. reconvictions) among prison leavers falls by a certain percentage compared to a control group of short-sentence prisoners in the UK. There are two targets, as outlined below:

- (i) A 10% reduction in reoffending for each cohort of 1,000 prisoners needs to be achieved for investors to receive payments for each cohort.
- (ii) If the 10% target is not met for any of the three cohorts, the three cohorts will be evaluated together at the end of the SIB. If a reduction in reoffending of 7.5% is achieved across all 3,000 offenders, investors will receive a payment.

The value of the payments is linked to the number of reduced reconviction events. If the 10% target reduction in reoffending is met across all 3 cohorts, investors are expecting an annual rate of return of around 7.5%. Depending on the scale of the reduction in reconviction events, investors may receive higher returns, up to a maximum annual rate of around 13%.

If the SIB achieves its target of reducing reconvictions by at least 10% for the first cohort, investors can expect to receive their first outcome payment around three to four years after their initial investment. This lag arises because it will take around 2 years to recruit a cohort of 1,000 offenders discharged from prison and the cohort will then need to be assessed for reoffending over a one year period following discharge.

The Ministry of Justice commissioned an independent evaluation of the SIB and the first [report](#) by RAND Europe was published in May 2011.²¹ The aim of the report, which was based on stakeholder interviews, was to identify initial lessons from the Peterborough SIB which might inform future SIBs. The report refers to issues including:

- the need for Departmental investment and creativity,
- the complexity of SIB contracts;
- the need to anticipate barriers to investment (e.g. tax rules);
- the need to consider the length of time until the first payment is made to investors.

Other Social Impact Bonds are also being considered or trialled. Councils in Liverpool and Essex "conducted feasibility studies to explore the potential of a Social Impact Bond to fund preventative services to support vulnerable children and their families, particularly to prevent care entry".²² Leicestershire Council has also proposed a SIB to tackle obesity.²³

On 26 August 2011, the UK Government [announced](#) another trial of Social Impact Bonds "to fund intensive help for families blighted by anti-social behaviour, crime, addiction and poor education".²⁴ The Cabinet Office stated that £40 million could be

raised for the pilots in four communities.²⁵ It noted that SIBs were supported in a 2011 [report](#) to the Prime Minister on early intervention.

Another notable development is the [launch](#) in July 2011 of Big Society Capital, which is "a financial institution that aims to develop a market for investment made on the basis of social impact as well as financial returns".²⁶ BSC will support organisations that invest in the social sector, including by investing in financial products like SIBs.²⁷ BSC will receive £600 million in equity capital from dormant bank accounts and the big four banks.²⁸

7. New South Wales pilot

7.1 Centre for Social Impact report:

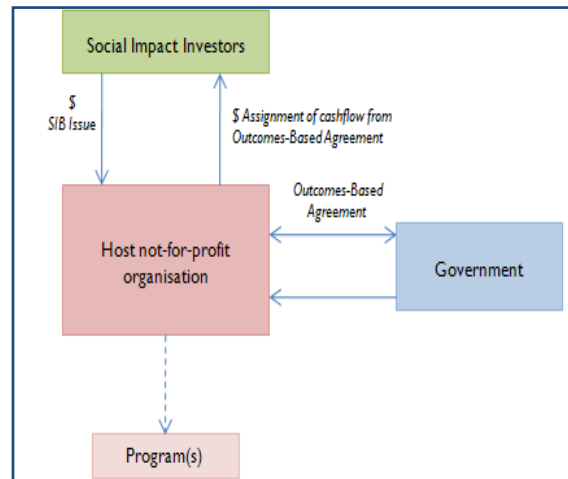
In its February 2011 [report](#), the Centre for Social Impact (CSI) concluded that:

...the SIB concept is feasible in the NSW context, and that NSW has the necessary market conditions for this new approach to funding to be trialled. CSI therefore recommends that the NSW Government proceeds to the next stage and invites expressions of interest from NPOs [not-for-profit organisations] that satisfy the key criteria for the development of a SIB.²⁹

The two policy areas that were identified as having potential for a pilot in NSW were: (1) juvenile justice, and (2) parenting skills for at-risk families. CSI also stated that:

CSI believes there is a strong pipeline of NSW-based programs and host NPOs which, with further work, may be feasible for SIBs in the medium to long term. The further work will require a special emphasis on development and use of robust evidence in the effectiveness of social programs and interventions, the development of performance measurement systems and collaborative relationships with government agencies.³⁰

CSI recommended that a NSW pilot be structured such that investors and government have a direct relationship with a chosen host NPO rather than having an intermediary, which was the model adopted in the UK pilot.³¹ CSI noted that some investors had expressed a preference to have a direct relationship with the NPO. The proposed model is shown below.³²



CSI developed various options for the SIB structure, which illustrated different levels of risk sharing across government, the NPO and social investors. CSI recommended that the Government adopt a model whereby:

...part of the costs the NPO incurs delivering the program will be paid by government through a standing charge, and the remaining costs and reward payment will be dependent on the achievement of a successful outcome. The exact level of the standing charge will be the subject of negotiation between the NPO and government, where the NPO is not only assessing its confidence in delivering the agreed outcome but is also sensitive to the preferences of potential social investors. Government may wish to minimise the level of the standing charge but will also be aware that the NPO and social investors will have limits.³³

CSI also outlined the options for measuring the performance of the program. Two of these options were:

- a randomised control trial approach, where potential clients of the program are randomly allocated to the 'treatment' or 'non-treatment' categories; and
- a quasi-experimental approach, where program participation is left to follow its normal course and the treatment cohort is compared to a control cohort after controlling for differences in the composition of the two cohorts (as with the UK pilot).³⁴

In terms of oversight, CSI recommended that the SIB pilot be subject to independent auditing and also be overseen by an expert advisory committee.³⁵ This committee could "help design the audit and annual reporting protocols and provide expert advice to all stakeholders".³⁶

7.2 Request for Proposal: On 30 September, the NSW Government released a [Request for Proposal](#) to identify two pilot Social Benefit Bonds in the areas of recidivism (adult and juvenile offender populations) and out-of-home care (i.e. children who are in, or facing placement in, foster care).³⁷

The basic parameters of the proposed pilots are outlined below.³⁸

- **Structure:** The Government intends to enter into a contract with a "Social Benefit Partner". The SBP may be a single organisation or consortium; it may involve not-for-profit and for-profit organisations; and it may be involved in service delivery or sub-contract service delivery to other providers. The SBP will be the debt issuer and will have ultimate responsibility for achieving the agreed outcomes.
- **Payments:** Payments should cover different levels of achievement against the agreed outcomes. The payment structure will be negotiated, but at least four scenarios are envisaged:
 - *Baseline level* will represent the break-even point for the Government and is likely to entail repayment of principal but no (or minimal) reward;
 - The consequences of *below baseline performance* would need to be negotiated, but the risk should reside with investors and not Government;
 - *Good performance* would entail financial benefits for Government and would result in a reasonable market return.
 - *Over performance* would entail significant financial benefits for Government and would result in the highest payments.
- **Risk allocation to SBP:** The Government is open to an arrangement where the SBP bears some financial risk and is able to share in the possible returns. However, it believes that the bulk of the risk (and returns) should reside with investors.
- **Term:** The term must balance the time needed to demonstrate maintenance of statistically significant effect sizes with investors' interest in receiving a return within a reasonable time frame. A term of five to eight years is envisaged.
- **Measuring performance:** The preferred method for measuring outcomes is randomised control

trial but other approaches may be considered. A measurement period of 2 years provides a high level of confidence for the sustained effectiveness of an intervention but this will need to be balanced against investors' interest in receiving a return within a reasonable time period.

- *Audit:* Independent auditors will be commissioned to determine whether the performance thresholds have been met.

The closing date for making a proposal was 24 November 2011. The following timetable has been proposed:

- Early 2012: preferred proponents to be advised;
- Early to mid 2012: development process for SBB;
- Mid to late 2012: signing of SBB agreement.³⁹

An [article](#) in the *Sydney Morning Herald* on 23 November reported that the Ted Noffs Foundation had raised concerns about the SIB tender (in particular, that it favoured the larger charities) and it had asked for the closing date to be pushed back.⁴⁰

8. Senate Committee report

On 25 November 2011, the federal Parliament's Senate Economic References Committee published a [report](#) on the development of a capital market for the not-for-profit sector in Australia.⁴¹ The Committee noted the global context for its inquiry:

In the current era of fiscal restraint and ongoing economic uncertainty, it is imperative that governments, philanthropists and mainstream investors maximise the value of their financial investments. Governments are increasingly constrained in their ability to

fund social service delivery, and there is an emerging realisation that 'the resources of government and philanthropy alone are insufficient to address the world's biggest problems'.

In this context, there is a great need for innovative and creative solutions to social and environmental problems, and governments around the world are turning to the emerging fields of the innovation of social enterprises and 'impact investment' to foster these solutions. These approaches involve mobilising capital from a broader range of sources than traditionally associated with the social economy sector, including mainstream banks, superannuation funds, wholesale investment funds and retail investors.⁴²

The Committee noted that the Federal Government's main initiative in this area was the establishment of the [Social Enterprise Development and Investment Funds](#).⁴³ The Government is providing \$20 million in seed funding for the Funds, which will provide finance and support (but not grants) to social enterprises. In August 2011, the Government announced that it had selected managers for the Funds.

The Committee's key recommendation was that the Government establish a Social Finance Taskforce to "assess mechanisms and options in the progress and development of a robust capital market for social economy organisations in Australia".⁴⁴ It noted that this type of body had worked well overseas (in the UK and Canada).

The Committee recommended that the Taskforce consider a number of issues as part of its remit including:

- the potential for philanthropic trusts and foundations to invest a percentage of their corpus in social investments options;
- the potential for superannuation funds and other institutional

investors to invest in emerging social investment products;

- possible options to develop Community Development Financial Institutions.⁴⁵

The Committee made several other findings and recommendations. In relation to SIBs, the Committee came to the following conclusion (in part):

The development of a social bond market in Australia could bring significant finance to the social economy and thereby relieve the government of some social infrastructure costs. There are, however, significant hurdles to overcome in order to attract investors to this market. The lower rate of return on a social bond coupon (due to the social dividend component) presents challenges when competing in the commercial market. As a result, the current market for social bonds would be somewhat limited, and most suited to investment minded philanthropists.⁴⁶

The Committee recommended that:

- Treasury and the Department of Finance and Deregulation should examine ways to create incentives to invest in a social bond market in Australia including the feasibility of tax exempt income returns; and
- The Government's Office for the Not-For-Profit Sector should:
 - identify policy areas where SIBs could be applied, including intractable problems in indigenous communities;
 - examine the plausibility of creating SIBs in partnership with state governments;
 - work with relevant government departments and agencies and

social organisations to implement a SIB trial.⁴⁷

9. Conclusion

SIBs are an innovative funding mechanism that offer a number of potential benefits including a focus on outcomes instead of inputs, and the investment of additional resources in early intervention. However, a number of challenges have been identified as well as factors that are likely to be critical to the success of SIBs. The development of SIBs will also depend on the scale of investor interest.

The UK pilot and the proposed pilot in NSW will provide a good opportunity to evaluate the SIB model. It will also be interesting to see whether the Federal Government implements a SIB trial (for example, to address indigenous disadvantage) as recommended by the Senate Committee. The Committee also recommended exploring other options to develop the capital market for the not-for-profit sector.

In a [paper](#) for the Center for American Progress, Jeffrey Liebman concluded with this perspective on SIBs:

We will almost certainly discover that this approach is not a panacea to the performance problems that bedevil our social programs. Still, any new policy tool with the potential to accelerate solutions in even a subset of our nation's most pressing social problems is an important breakthrough – one that deserves careful consideration from the policymaking, philanthropic and investment communities.⁴⁸

¹ The Centre for Social Impact, *Report on the NSW Government Social Impact Bond Pilot*, February 2011, p12-13

² NSW Treasury, *NSW Budget Papers 2011-12 – Budget Paper No. 1*, p14

- ³ NSW Treasury, *Request for Proposal: Social Benefit Bonds Trial*, 30 September 2011.
- ⁴ Kristina Keneally, 'Social Impact Bonds – First in Australia', *Media Release*, 25 November 2010.
- ⁵ Centre for Social Impact, note 1
- ⁶ Ministry of Justice, Social Finance, 'Minister launches Social Impact Bond pilot', *Media Release*, 10 September 2010.
- ⁷ US Office of Management and Budget, 'Paying for Success – The Federal Budget Fiscal Year 2012, [\[Online\]](#)
- ⁸ For examples in the UK, see C Kernot, 'Social Impact/Social Benefit Bonds grow...an update', 4 November 2011 [\[Online\]](#). One example is the launch by the disability charity Scope of a £20 million to finance the growth of its fundraising program and network of charity shops.
- ⁹ This is based on G Mulgan et al, *Social Impact Investment: the challenge and opportunity of Social Impact Bonds*, Young Foundation, March 2011, p7.
- ¹⁰ Centre for Social Impact, note 1, p7
- ¹¹ This is based on G Mulgan et al, note 9 p11
- ¹² See G Mulgan et al, note 9, p12
- ¹³ Centre for Social Impact, note 1, p23
- ¹⁴ NSW Treasury, *Social Benefit Bonds Trial in NSW FAQs*, [\[Online\]](#)
- ¹⁵ G Mulgan et al, note 9, p5-6
- ¹⁶ G Mulgan et al, note 9, p17
- ¹⁷ NSW Treasury, note 14
- ¹⁸ G Mulgan et al, note 9, p21. See also J Liebman *Social Impact Bonds: A promising new financing model to accelerate social innovation and improve government performance*, Center for American Progress, February 2011, p18
- ¹⁹ The following information is primarily taken from Social Finance, [Peterborough Social Impact Bond](#), 2011; and E Disley et al (Rand Europe), [Lessons learned from the planning and implementation of the Social Impact Bond at HMP Peterborough](#), Ministry of Justice, May 2011
- ²⁰ This diagram is taken from Social Finance, [A Technical Guide to Commissioning Social Impact Bonds](#), November 2011, p5
- ²¹ E Disley et al (Rand Europe), note 19.
- ²² Cabinet Office, 'Big Society innovation aims to get families out of deprivation', *Media Release*, 26 August 2011.
- ²³ C Kernot, note 8
- ²⁴ Cabinet Office, note 22
- ²⁵ Cabinet Office, note 22
- ²⁶ Big Society Capital, 'Big Society Capital Launch', *Media Release*, 29 July 2011.
- ²⁷ Big Society Capital, [\[Online\]](#)
- ²⁸ Big Society Capital, note 26
- ²⁹ Centre for Social Impact, note 1, p11
- ³⁰ Centre for Social Impact, note 1, p20
- ³¹ Centre for Social Impact, note 1, p34
- ³² Centre for Social Impact, note 1, p34
- ³³ Centre for Social Impact, note 1, p10.
- ³⁴ Centre for Social Impact, note 1, p42-43.
- ³⁵ Centre for Social Impact, note 1, p52
- ³⁶ Centre for Social Impact, note 1, p52
- ³⁷ NSW Treasury, note 3
- ³⁸ This is taken from NSW Treasury, note 3, p12-15
- ³⁹ NSW Treasury, note 3, p39
- ⁴⁰ M Steffens, 'Smaller non-profits fear being left behind in NSW's experiment with social funding', *SMH*, 23 November 2011
- ⁴¹ The Senate, Economics and References Committee, *Investing for the good: the development of a capital market for the not-for-profit sector in Australia*, November 2011.
- ⁴² Senate Committee, note 41, p9-10
- ⁴³ Senate Committee, note 41, p187
- ⁴⁴ Senate Committee, note 41, Recommendation 2.1, p34-35
- ⁴⁵ Senate Committee, note 41, Recommendations 4.3, 4.4, 5.2
- ⁴⁶ Senate Committee note 41, p156
- ⁴⁷ Senate Committee, note 41, Recommendations 6.2, 6.3, p157-158
- ⁴⁸ J Liebman, note 18, p29

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