SOCIAL IMPACT BONDS

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Social impact Bonds, a new investment tool available to grantmakers, can help leverage private sector funds to increase the success of public sector programs. The following information is a summary for grantmaking organizations about Social Impact Bonds and how they can be used.

What is a Social Impact Bond (SIB)?

Preventing social and health problems saves the public sector money in the long run, but it is difficult for public bodies to find the funds and incentives for preventive approaches. The private sector, on the other hand, may have funds available to help forestall or solve social and health problems, but doesn't benefit from doing so, as any savings go to the public sector. A Social Impact Bond (SIB) is a contract between the private and public sectors in which a commitment is made by a private entity to pay for improved social services whose outcomes are expected to result in significant public sector savings. Those public sector savings are then used as a basis for repaying investors, assuming that specified social outcomes and savings are achieved.

Social Impact Bonds are not bonds in the conventional sense. While they operate over a fixed period of time, they do not offer a fixed rate of return. Rather, the government will repay the investors only if a predetermined goal, established during the issuance of the bond, is accomplished. Essentially, the government will only pay for what works.

The government uses private sector money obtained via a Social Impact Bond to support nonprofits that are ready to grow and enlarge their impact on society. These nonprofits are typically providing services that have been demonstrated to be effective, or show promise of high-impact. With the financial support provided from the SIB, these nonprofits can spend less time raising funds, allowing them to focus more time on increasing their social impact. This enhanced social impact creates government savings in both the short term and long term. The risk of funding social innovation projects is transferred to the private sector, and the accountability of using taxpayers' money for more high-impact projects is increased. This is also referred to as "Pay for Success."

Why is it called a bond if it does not act like a traditional debt investment?

A bond is a debt instrument wherein an investor loans money to an issuer for a defined time at an agreed-upon interest rate. A Social Impact Bond typically has a defined time period, but it does not have a fixed rate of return. Thus a SIB is more accurately described as a hybrid financial instrument with characteristics of both debt and equity. For example, there is an upper limit on the returns from the investment (debt/bond), but also a potential return based on performance (equity).

How long does a typical Social Impact Bond last, i.e., when does it mature?

Five to seven years.

What is the targeted return on investment (ROI) for a typical Social Impact Bond?

The estimated return on a successful SIB is between 5% and 9%.

Is there any guarantee that the invested money is safe?

This answer will differ among all Social Impact Bond issuance agreements. One way to reduce risk is for the nonprofit organization receiving money from the SIB to have a minimum guaranteed cash flow – an amount of money coming in throughout the term of the bond, or to have a designated reserve fund to back the investment and mitigate a portion of the risk for investors. This is one area where SIBs greatly differ from traditional bonds, because the principal may not be guaranteed in the issuance agreement.

For example, the first U.S. Social Impact Bond that is in the early stages of development in New York has $7.2 of the $10 million investment backed by Mayor Bloomberg's personal foundation, Bloomberg Philanthropies.

Has this been done before?

Social Impact Bonds are gaining acceptance in the United Kingdom, Australia, and New Zealand. The first SIB is in development in Peterborough, UK. This particular SIB aims to reduce recidivism after release from prison. The UK organization Social Finance has produced an excellent outline of this project and a detailed project report.

Goldman Sachs is investing in a SIB with New York City that is currently being developed and is the first project in the U.S. This project aims to reduce recidivism rates among 16 to 18 year olds released from Rikers Island Jail.

What are the risks associated with Social Impact Bonds?

When multiple parties are involved in financing and delivering services, there are always a number of risks. The nonprofit organization delivering the services must be qualified to manage the finances and provide quality services that will actually result in reduced public investment. Potential risks to the public must be minimized, even if the funded project is not successful. Repayments to investors must be protected from political intervention. For more discussion of the potential risks associated with SIBs, see the Social Finance publication, A New Tool for Scaling

Impact: How Social Impact Bonds Can Mobilize Private Capital to Advance Social Good.

How will risk be dealt with?

To help minimize risk, Social Impact Bonds use an intermediary to link the private investors, nonprofits, and governments. Intermediaries are nonprofits whose primary goal is to facilitate social impact, and benefit society. The intermediary creates the specifications of the bond, structures the government contracts, and oversees the project from start to finish to keep the beneficiary accountable.

The intermediary has the legal authority to get involved with the project in which the bond is invested. This power comes from specifications within the bond. A skilled intermediary will be certain to negotiate all the legal powers it needs to oversee a SIB most effectively. This is to ensure that the investors feel that their money is in safe hands.

Intermediaries have the power to oversee the SIB investment over many areas. After securing the government contract, the intermediary will receive periodic financial data and statistical updates from the nonprofit to confirm the investment is going according to plan.

Intermediaries also have the financial expertise that nonprofits may not have, which will enable the nonprofits to focus more time on creating a positive social impact rather than raising money. The intermediary essentially acts as a consultant to the entity being invested in and will aid them with any problems or hurdles they encounter.

What incentives do intermediaries have to make sure the investment is safe?

If the funded project is not going according to plan, the intermediary has power (established in the bond specifications) to step in and alter the existing model.

Intermediaries have two motives to establish a safe investment. The first is social impact. Intermediaries promote "impact first" investing, which means that a social benefit is considered to be a return on the investment. There is also a financial motive tucked in behind the scenes, because intermediaries will benefit, just as the investors will, if the SIB initiative is successful.

What is the role of Social Impact Bonds for grantmaking foundations?

There are several reasons why Social Impact Bonds make sense for foundations. First and foremost, SIBs can have a positive impact on society, and investing in the social good can benefit a foundation's public image more than the monetary return from traditional financial investments can.

Second, it is no secret that foundations need money to operate, just like any other entity in this world. SIBs can be an effective way to generate investment revenue. Investing in a SIB will align the foundation's desire to benefit society, in whatever sector that may be, with the need to generate earnings from investments. There is risk involved that will fluctuate based on the bond issuance, but this is a risk that foundations should be willing to take considering that traditional grants don't have the possibility for a return on investment. In other words, a foundation can think of this as a grant to an organization that will better society, and a return on their investment is simply an added benefit that has not been there before.

And finally, Social Impact Bonds have massive potential to generate a true change on the monetary influence that private sector money can have for social benefit.

Do Social Impact Bonds make sense for smaller foundations?

Depending on a foundations' investment portfolio, there will most likely be SIBs that will fall under any level of investment. What will really make the difference in feasibility for smaller foundations is how the IRS decides to treat a SIB investment (see next section).

Does a Social Impact Bond fall under the 5% payout rule?

The IRS requires that private, non-operating foundations expend at least 5% of their previous year's average net investment assets on charitable purposes. This law allows the 5% payout to come from interest earned on a foundation's endowment rather from the endowment itself. As a result, many foundations spend a lot of time focusing on their investment performances to ensure that they make enough interest to cover the 5% of assets that need to be paid out to charitable purposes each year.

The very recent emergence of Social Impact Bonds means that the Internal Revenue Service is still evaluating whether SIBs count as part of the 5% payout. But as of 2012, one of the selling points of SIBs is that this financial tool will be able to be applied as part of the 5% of net assets expenditure. If this is the case, foundations will not have to spend as much time or effort on investment performance to cover this 5% of net assets. Rather they could confidently invest money in a SIB to fulfill the 5% payout, and most likely see a return from the investment that can be used for future grants or SIBs.

How is a Social Impact Bond different from a Program-Related Investment?

Program-related investments (PRIs) are investments made by foundations to support charitable activities that involve the potential return of capital within an established time frame. PRIs include financing methods commonly associated with banks or other private investors, such as loans, loan guarantees, linked deposits, and even equity investments in charitable organizations or in commercial ventures for charitable purposes.

SIBs and PRIs are comparable, but not identical. PRIs, like SIBs, often use an intermediary to vet the project and assure the investor that they will get their money back with stated interest. Unlike SIBs, PRIs have a stated duration and interest rate (although often below market rate), making them more like a traditional bond than an SIB.

Like SIBs, PRIs also count towards the 5% payout. Loan repayments to the foundation under PRIs must go out again in the year they are received through grants or new PRIs.

How is a Social Impact Bond different from a municipal bond?

A municipal bond is one that is issued by a government entity (below the state level) that is used to raise capital for infrastructure needs of that particular entity. The needs can vary widely, but may include schools, highways, public housing, hospitals, utility systems, etc.

SIBs are intended to create savings for the government while improving social programs. Municipal bonds are intended to raise money for the government to carry out diverse projects. Municipal bonds have either a fixed or variable rate of interest, as opposed to a SIB where the government will only repay the investors if a specific socially-driven goal is reached through funding of the social program.

Will Social Impact Bonds cause the government to stop moving ahead with social programs?

SIBs can actually enlarge the amount and impact of social programs. The government does not have the ability to pay for both remedial and preventative programs at the same time. One of the main benefits of SIBs is that they can decrease the cost of remedial programs by creating early intervention programs. Savings that the government experiences from SIBs will allow it to allocate funds to other project that will better serve citizens and extend the positive feedback loop.

What social issues or problems do not make sense for Social Impact Bonds?

Any area where it would be very difficult to determine a clear goal or outcome for which to strive. Also, any area where even though you can determine what a clear goal or outcome would be, you don’t have evidence that there are any proven methods for achieving that goal that would assure private investors that their dollars will provide a return on investment. A good example is policing. It is hard to design a measurable outcome for a SIB that provides additional funding to a police department. Social areas that can have clear, tangible outcomes like education, recidivism, or health care are the best fits for SIBs.

How can grantmaking foundations best incorporate Social Impact Bonds into their portfolios?

The push to get SIBs rolling has already taken place in the U.S. with the Goldman Sachs' investment. This SIB specifically targets the reduction of recidivism rates among incarcerated teens. The appeal of SIBs is that they benefit society. The areas that SIBs can be applied to are so varied that any foundation should be able to find one that aligns with their core mission and objectives. Though the government may deem certain social initiatives as too risky to allocate money towards, private investors and foundations are in good positions to bear this risk in order to see a much larger scale of social outcome. SIBs can be invested in entities and projects that are ready to be scaled up to increase their impact on society.

From a business perspective, it is necessary to pick and choose smart investments with adequate yields to continue business. This is no secret. From a societal standpoint, it is essential to be involved in activities that affect people on more than just a monetary level and elevate living standards for society. These two outlooks can now be aligned through Social Impact Bonds, where business motives can be coupled with social impact.

RESOURCES

Issue Overviews

An Introduction to Social Impact Bonds
McKinsey & Company has created an easy to understand, three-minute video that is helpful to gain a general understanding of how SIBs work, and is the quickest way to get a full overview of a SIB. This is a great place to start before diving into more specific areas of this new financial tool.
Source: McKinsey & Company, May 2012

The Promise of Social Impact Bonds
An opinion piece on how promising and beneficial SIBs can be in the U.S. through an anecdotal example from the first SIB in Peterborough, United Kingdom. It gives a clear summary of how a SIB works in addition to several areas of application that help understand the general market for SIBs.
Source: The New York Times, June 2012

In-Depth Information on Social Impact Bonds

From Potential to Action: Bringing Social Impact Bonds to the US
McKinsey & Company is leading the pack with resources and research about SIBs. This is a comprehensive guide to SIBs that includes the basics, potential benefits, specific applications, in-depth descriptions of components, and possible challenges. Addressing homelessness and issues in the criminal justice system are discussed to create a general understanding of the scale and type of issues that can be prevented or curbed through SIBs. Be sure to read the analysis of the hypothetical SIB that includes real data from the juvenile justice system of Washington State.

Source: McKinsey & Company, May 2012

[A New Tool for Scaling Impact: How Social Impact Bonds Can Mobilize Private Capital to Advance Social Good]
Social Finance has created this source to give an overview of the potential impact, structure, and challenges of implementing SIBs. This discusses the logistics, parties involved, risks, and applications in a condensed form. This resource delves into the risk mitigation that will need to take place in order for SIBs to be successful. Social Finance is the sister nonprofit to Social Finance UK, which has implemented the first SIB in the world (see Peterborough SIB resources below).
Source: Social Finance, 2012

[Social Impact Bond Webinar Panel]
This video sponsored by McKinsey & Company includes a columnist from the Washington Post, the CEO of Social Finance, a senior expert at McKinsey Social, and a professor at the JFK School of Government. This panel speaks about the general logistics of a SIB, the potential market, and the transfer of capital and financial risk. Specifically it addresses how SIBs will bridge the gap between philanthropy providing all of the risk capital for pilot programs, and the government waiting for them to find something that works before adopting it. The panelists include leading experts in the emerging SIB industry and provide a good background to the concept and the SIB terminology.
Source: McKinsey & Company, May 2012

[Q & A to the McKinsey Webinar Panel]
The Q & A portion of the webinar is just as beneficial as the initial discussion. The questions raised include the risk investors will have to deal with, how prepared nonprofits will be to scale up productivity with the increased capital, and how realistic SIBs are for tackling issues like illiteracy and unemployment. The applicability of Benefit Corporations, or "B-Corps", to SIBs is mentioned in this session. These are for-profit companies that aim to create both profit and positive social impact. The experts forecast opinions on future applications like targeting the unemployment rate.
Source: McKinsey & Company, May 2012

Examples of Social Impact Bond Activity

[Goldman to Invest in City Jail Program, Profiting if Recidivism Falls Sharply]
A *New York Times* article from August 2012 provides an overview of the developing SIB in New York City. Here, the private investor is the for-profit Goldman Sachs, not a foundation. This project is a breakthrough for social impact investing in the US, and will be extremely important for the future of SIBs. This pilot SIB is largely made possible by the support from Mayor Bloomberg's foundation (Bloomberg Philanthropies) because it is guaranteeing a large portion of the investment.
Source: *New York Times, August 2012*

[Bringing Social Impact Bonds to New York City]

Brief summary of the future SIB in New York City that will aim to reduce recidivism among 16 to 18 year olds incarcerated in Rikers Island Prison. This summary includes the funding and potential returns on the investment for investors and the government savings.
Source: *City of New York, August 2012*

Peterborough Social Impact Bond
This is useful for a very brief description of a SIB, the structure of the Peterborough (United Kingdom) model, and basic FAQs of the project.
Source: Social Finance, UK, 2011

Social Impact Bonds: The One Service. One Year On
This is the best resource to get a full overview of the Peterborough Model SIB launched in the UK. The Peterborough Model is important to understand, because it is the first and only fully-developed SIB to date. This report covers the process of SIB creation, why targeting recidivism rates are right for a SIB, and in-depth statistics that are essential for a successful SIB.
Source: Social Finance UK, November 2011

Lessons Learned from the Planning and Early Implementation of the Social Impact Bond at HMP Peterborough
Official report from the Ministry of Justice that is the best source to research the ongoing performance of the SIB and how it is being evaluated. At the end of every issue analyzed, there is a section devoted specifically to offering advice for future SIBs. This is of great use to those considering SIBs in the U.S.
Source: UK Ministry of Justice, May 2011

For Grantmakers

Five Percent Payout Rule
One of the most important factors that will dictate whether SIBs take off in the U.S. is how the IRS decides to treat SIB investments and interest. This brief FAQ on the five percent rule will help better understand why this could create a boom or bust in SIB investing.
Source: Minnesota Council on Foundations, 2009

Program-Related Investing: Skills and Strategies for New PRI Funders
A guide for grantmakers on making program-related loans and investments. Included are examples from experienced funders and tips and strategies for grantmakers new to this approach.
Source: GrantCraft, 2006

Web Sites to Explore

Social Finance: www.Socialfinance.org.uk

McKinsey & Company: www.mckinseyonsociety.com

The White House, Office of Management and Budget:
http://www.whitehouse.gov/omb/factsheet/paying-for-success
A description of the plan to integrate pay for success into the federal budget and what areas of society and government will benefit.

The Bridgespan Group: http://www.givesmart.org/job/What-Is-Impact-Investing_Should-You-Consider-It.aspx
For tips and useful information on philanthropy.

Guidestar: http://www.guidestar.org
For public information on nonprofit organizations.

When researching Social Impact Bonds online, consider using these search terms:

- Social impact
- Pay for success
- Peterborough
- Impact first investing
- Benefit corporation
- Goldman Sachs
- Rikers, ABLE (Adolescent Behavioral Learning Experience)