A NEW TOOL FOR SCALING IMPACT:
HOW SOCIAL IMPACT BONDS
CAN MOBILIZE PRIVATE CAPITAL
TO ADVANCE SOCIAL GOOD
CONTENTS

4 Executive Summary
6 Market Context
8 The Promise and Challenges of Social Impact Bonds
  10 How Social Impact Bonds Work
  16 Key Players
  20 Potential Risks
  22 Risk Mitigation through Intermediation
26 Promising Initial Social Impact Bond Applications
31 Conclusion
INTRODUCTION BY JUDITH RODIN
President, The Rockefeller Foundation

The Rockefeller Foundation’s mission to promote the well-being of humanity has remained unchanged since its founding in 1913. In a rapidly changing world, we use an innovative and interconnected systems-based approach that combines civil society, private and public sector resources to solve social problems.

It was with this collaborative approach in mind and our goal to find solutions from unlikely sources that the Foundation embarked on its innovation initiative, which aims to test whether new innovative approaches can be applied within development and achieve social good. Simultaneously, the Foundation began its work to build the impact investing sector based on the premise that the resources of government and philanthropy alone are insufficient to address the world’s biggest problems.

Social Impact Bonds—“or Pay for Success Bonds”—sit at the nexus of our work in impact investing and scaling innovation, and represent one component of the rapidly growing field of innovative finance that the Foundation has long supported and will continue to support as it evolves and changes in the future.

Social Impact Bonds have the potential to substantially transform the social sector, support poor and vulnerable communities, and create new financial flows for human service delivery by offering an innovative way to scale what works and break the cyclical need for crisis-driven services. They are an exciting field of innovative finance, but one we need to approach thoughtfully. This publication offers a framework for both the promise and challenges of Social Impact Bonds as state and local governments within the US begin to explore this new innovation.

The Rockefeller Foundation has been proud to support the growth of Social Impact Bonds from the very beginning, as a funder for Social Finance UK and as an investor in the Social Impact Bond pilot in Peterborough, UK. The Rockefeller Foundation is committed to testing the effectiveness and scalability of this model, and we pride ourselves on using our risk capital in service of innovation.

The Foundation sees great opportunity for Social Impact Bonds in the United States and is proud to have both commissioned this report from Social Finance US as well as providing support for Social Finance US’s continued work to assess the scalability of Social Impact Bonds in America.

We hope that this publication and the ongoing work of Social Finance US serve as an important step to advance the field of innovative finance.

JUDITH RODIN
President, The Rockefeller Foundation
FOREWORD BY TRACY PALANDJIAN
CEO, Social Finance, Inc.

In September 2010, our sister organization, Social Finance, Ltd., launched the world’s first Social Impact Bond in the United Kingdom. Targeted at reducing prison recidivism, the Peterborough pilot generated world-wide interest in the potential of this innovative financial instrument. We established Social Finance, Inc. in January 2011, to bring the Social Impact Bond to the United States. Since our founding, we have been collaborating with government, investors, nonprofit organizations, and thought leaders on how Social Impact Bonds might realign incentives for delivering social outcomes and augment public funding and philanthropy to support our collective efforts to improve the lives of individuals and communities in need.

At its core, the Social Impact Bond is about partnership. We are grateful to the Rockefeller Foundation and our other founding partners who share our commitment to mobilizing investment capital to drive social change. The momentum that Social Impact Bonds have brought to the larger impact investing industry has been inspiring; yet there is much work to be done. Successful collaboration with a broad range of constituents, thoughtful design of an innovative and complex instrument, and diligent execution of transactions will be critical to realizing the promise of Social Impact Bonds.

Most recently, we have witnessed an important milestone in this nascent industry’s efforts. In May 2011, Massachusetts became the first state in the country to take formal steps to create a comprehensive social innovation financing program to deploy Social Impact Bonds and pay-for-success contracts. In January 2012, Massachusetts issued Requests for Response for performance-based financing to expand support for chronically homeless adults and youth exiting the juvenile justice system. The Commonwealth’s pioneering efforts stand to validate the potential of Social Impact Bonds: to improve social outcomes at reduced taxpayer expense, transfer performance risk from government to investors who might be more able to price and bear it, and reward high-performing nonprofits with long-term growth capital to scale proven innovations.

The purpose of this publication is to provide an overview for a broad audience of both the promise and challenges of developing and implementing Social Impact Bonds in the United States. Despite the many complexities, multi-stakeholder interactions, and varying dimensions of risks, Social Impact Bonds represent a potentially valuable new tool for scaling social impact.

TRACY PALANDJIAN
CEO, Social Finance, Inc.
Executive Summary

The United States is home to almost a million charitable organizations that provide vital services to vulnerable individuals and communities. Though they are bringing innovation to bear on intractable social problems, these organizations collectively serve only a small fraction of those in need. Limited funding—especially the lack of long-term funding—constrains nonprofits’ growth and contributes to a high degree of fragmentation within the social sector. Even nonprofits with the strongest track records are unable to significantly expand their services and benefit a wider portion of the population.

Today nonprofits have a new source of capital to scale evidence-based interventions: Social Impact Bonds (SIBs). Aligning the interests of nonprofit service providers, private investors, and governments, SIBs raise private investment capital to fund prevention and early intervention programs that reduce the need for expensive crisis responses and safety-net services. The government repays investors only if the interventions improve social outcomes, such as reducing homelessness or the number of repeat offenders in the criminal justice system. If improved outcomes are not

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1 Social Impact Bonds are also referred to as Pay-for-Success Bonds. Though they are called bonds, SIBs have both equity- and debt-like features.
achieved, the government is not required to repay the investors, thereby transferring the risk of funding prevention services to the private sector and ensuring accountability for taxpayer money.

While SIBs are not a panacea, they might provide a unique way to make effective interventions available to far more people in need than the number that can be reached through traditional state contracts and philanthropy. The best candidates for SIB funding are nonprofits with strong track records of improving outcomes for a well-defined target population. These outcomes translate into government savings that can be achieved within a relatively short time frame and are large enough to cover the program’s cost and a reasonable return to investors.

Dedicated intermediaries will be critical to the success of SIBs. Intermediaries can add value during each step of SIB development and implementation, including originating the deal, securing a government contract, structuring the instrument, and issuing the SIB. They attract investment capital, for instance, by creating and facilitating access to tools that allow investors to analyze, measure, and price the risk of the investment. Throughout the five- to ten-year life of the instrument, intermediaries play an especially important role in managing complex projects, mitigating risks, and helping service providers achieve targeted outcomes.

**THE SOCIAL IMPACT BOND IS A PROMISING NEW PRODUCT WITHIN THE IMPACT INVESTING SECTOR, WITH POTENTIAL TO BECOME A MULTI-BILLION DOLLAR SOURCE OF GROWTH CAPITAL TO FUND EFFECTIVE SOCIAL PROGRAMS.**

The Social Impact Bond is a promising new product within the impact investing sector, with potential to become a multi-billion dollar source of growth capital to fund effective social programs. Although the instrument is still in its infancy, interest in SIBs is steadily growing, with governments from the United States to Australia exploring the concept. Conducting pilots across different social issue areas and geographies will be essential in broadening understanding of how Social Impact Bonds can be implemented most effectively.
Market Context

Over the past few decades, many innovative programs have demonstrated success in their efforts to better the lives of our nation's most at-risk and vulnerable populations. Regrettably, these initiatives tend to remain small, collectively serving only a fraction of those who could benefit. Philanthropy has played a leading role in funding these innovations, supporting nonprofits as they tested, refined, and perfected their models. However, there is now a profound need for nonprofit growth capital—funding that is longer, larger, and more flexible—so that these interventions can be offered to many more people in need.

A major barrier to the growth of nonprofits lies in the nature of funding for the social sector. Traditionally, nonprofit programs and social services have been supported by government and philanthropy. While both are essential funding streams, they have been unable to meet the overwhelming need. Limited funds are spread thinly across a fragmented nonprofit landscape. Commitments tend to be of limited duration and too small to achieve scale. Furthermore, targeting funding to the most effective programs has proved challenging, as the social sector lacks sufficient measurement of participants’ outcomes. As a result, nonprofits spend significant amounts of time raising short-term money and are constrained in their ability to develop longer-term strategies.
Meanwhile, governments at all levels are struggling in the face of large deficits that reflect not only the lingering effects of the financial crisis, but also long-term structural gaps (with spending growing faster than revenues). As a result, governments are trapped in a vicious cycle: Limited resources for prevention programs, such as supportive housing and job training, leads to greater demand for safety-net services, such as shelters and prisons, followed by further reductions in early intervention programs that could reduce the need for remediation in the future.

Obstacles remain in the way of expanding effective nonprofit programs, but recent developments suggest there may be reason for optimism. Impact investing—actively investing capital to generate financial returns and social or environmental impact—has drawn substantial interest over the past few years. With the potential to spark significant progress, this approach could bring a large new pool of capital to bear on social problems. Unlike public-sector or grant funding, impact investments produce financial returns that can be reinvested in the social sector. In this way, capital can be recycled and returns can be used again to continue widening impact.

The confluence of these factors—the need for nonprofit growth capital, shrinking government budgets, and the growth of impact investing—has paved the way for the development of an innovative financial instrument: the Social Impact Bond.
The Promise and Challenges of Social Impact Bonds

The Social Impact Bond is designed to accelerate the expansion of evidence-based programs delivered by effective nonprofits. The world’s first SIB was launched in the U.K. by Social Finance, Ltd. in September 2010 (see page 9, “The World’s First Social Impact Bond”). Since then, governments around the world have expressed interest in launching SIBs of their own. Australia released a Request for Proposals on SIBs (which they refer to as “Social Benefit Bonds”) in September 2011. Governments and nonprofits in other countries, including Canada and Ireland, are actively exploring the concept as well. In the United States, President Obama proposed funding of $100 million for SIBs in his FY2012 budget, and Massachusetts became the first state to formally indicate its interest when it released a Request for Information on the instrument in May 2011. In January 2012, Massachusetts deepened its commitment to social innovation financing and the development of SIB contracts by issuing Requests for Response. Specifically, the Commonwealth asked intermediaries and nonprofits how SIBs might be used to provide stable housing for chronically homeless individuals and support youth exiting juvenile corrections and probation systems.

FOLLOWING BEN FRANKLIN’S MAXIM THAT “AN OUNCE OF PREVENTION IS WORTH A POUND OF CURE,” SIBS FUND EFFECTIVE PROGRAMS THAT TACKLE THE ROOT CAUSES OF HOMELESSNESS, CRIME, AND OTHER DISABLING ECONOMIC AND SOCIAL CONDITIONS.
The Promise and Challenges of Social Impact Bonds

The Social Impact Bond is designed to accelerate the expansion of evidence-based programs delivered by effective nonprofits. The world’s first SIB was launched in the U.K. by Social Finance, Ltd. in September 2010 (see page 9, “The World’s First Social Impact Bond”). Since then, governments around the world have expressed interest in launching SIBs of their own. Australia released a Request for Proposals on SIBs (which they refer to as “Social Benefit Bonds”) in September 2011. Governments and nonprofits in other countries, including Canada and Ireland, are actively exploring the concept as well. In the United States, President Obama proposed funding of $100 million for SIBs in his FY2012 budget, and Massachusetts became the first state to formally indicate its interest when it released a Request for Information on the instrument in May 2011. In January 2012, Massachusetts deepened its commitment to social innovation financing and the development of SIB contracts by issuing Requests for Response. Specifically, the Commonwealth asked intermediaries and nonprofits how SIBs might be used to provide stable housing for chronically homeless individuals and support youth exiting juvenile corrections and probation systems.

Following Ben Franklin’s maxim that “an ounce of prevention is worth a pound of cure,” SIBs fund effective programs that tackle the root causes of homelessness, crime, and other disabling economic and social conditions.

The World’s First Social Impact Bond

Social Finance (U.K.) launched the world’s first SIB in September 2010. The U.K.-based organization raised £5 million (~US$8 million) from 17 investors to fund a comprehensive reentry program (the One*Service) for short-sentenced prisoners leaving Peterborough prison over a six-year period. Prisoners serving sentences of less than a year typically receive little support upon release; they often leave with just £46 (~US$70) in their pocket and no housing, job, or family support. Consequently, over 60 percent become repeat offenders within one year. The SIB contracts organizations, including the St Giles Trust, Ormiston Children and Families Trust, the YMCA, and SOVA, to provide tailored wrap-around services to 3,000 prisoners before and after their release to facilitate successful reentry into the community.

For the most part, investors in the Peterborough SIB represent philanthropic sources of capital, including the Rockefeller Foundation, the Barrow Cadbury Charitable Trust, and the Esmée Fairbairn Foundation. The Ministry of Justice and the Big Lottery Fund have agreed to repay these investors if one-year post-release reconvictions decrease by at least 7.5 percent, relative to a comparison group. Because SIB performance is measured by the number of times ex-offenders are reconvicted, and not simply whether or not they reoffend, providers are encouraged to work with all prisoners leaving Peterborough, including the most prolific reoffenders. The SIB has an eight-year term, with capital drawdowns made annually in years one through six. Payments to investors, if they become due, occur in approximately years four, six, and eight. Returns are commensurate with social outcomes and will range between 2.5 percent and 13 percent.
HOW SOCIAL IMPACT BONDS WORK
Social Impact Bonds align the interests of nonprofit service providers, investors, and governments in an effort to improve the lives of individuals and communities in need. Their core feature is the provision of funding for upstream prevention or early intervention programs that significantly reduce the need for subsequent and more costly remediation. Following Ben Franklin’s maxim that “an ounce of prevention is worth a pound of cure,” SIBs fund effective programs that tackle the root causes of homelessness, crime, and other disabling economic and social conditions.

ALTHOUGH THEY RECOGNIZE THE ECONOMIC AND SOCIAL BENEFITS OF PREVENTION, GOVERNMENT AGENCIES GENERALLY CANNOT AFFORD EARLY INTERVENTION SERVICES AS THEIR FUNDS ARE ALREADY COMMITTED TO HIGH-COST REMEDIATION PROGRAMS.

Governments spend billions of taxpayer dollars each year on crisis-driven services. These programs help a great number of people, but fail to make much headway in solving social problems that have become too complex for one dimensional, prescriptive solutions. Although they recognize the economic and social benefits of prevention, government agencies generally cannot afford early intervention services as their funds are already committed to high-cost remediation programs. Indeed, even if they fund prevention, governments risk having to pay for both prevention and remediation if their chosen prevention programs fail to improve participants’ outcomes. The short-term imperatives of the election cycle exacerbate this tendency to shy away from potentially risky, longer-term preventative investments.

 Agencies also tend to work in silos, a structure that discourages collaboration on cross-cutting issues. For instance, homeless individuals impose significant costs on health and corrections agencies, yet solutions to homelessness are implemented by housing agencies. Because the costs of remediation and prevention are divided among departments, agencies often lack the incentive to collaboratively develop and deliver effective, integrated solutions at scale.

SIBs would address these problems by allowing governments to transfer the financial risk of prevention programs to private investors based on the expectation of future recoverable savings. They also provide the incentive for multiple government agencies to work together, capturing savings across agencies to fund investor repayment.

SOCIAL FINANCE, INC.
The power of SIBs lies in their ability to align all stakeholders’ interests around achieving common objectives for the benefit of poor and vulnerable populations. Stakeholders in SIBs—nonprofits, investors, government, and communities—would all benefit from successful SIB programs (see table 1).

**TABLE 1** **BENEFITS TO STAKEHOLDERS OF SUCCESSFUL SIBs**

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<th>STAKEHOLDERS</th>
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| Nonprofits   | ▶ Access to growth capital to scale up operations  
               ▶ Access to a stable and predictable revenue stream without labor-intensive fundraising  
               ▶ Facilitated coordination with organizations working on overlapping problems |
| Investors    | ▶ Achievement of financial returns and social impact  
               ▶ Participation in a new asset class with portfolio diversification benefits |
| Government   | ▶ Accountability for taxpayer funds  
               ▶ Reduction in the need for costly downstream remediation  
               ▶ Increased supply of effective services for citizens without financial risk |
| Communities  | ▶ Access to an increased supply of effective social services  
               ▶ Reduction in the need for crisis-driven interventions |

High-performing nonprofit service providers would have unprecedented access to growth capital to expand their operations. This stable and predictable revenue stream would allow them to spend less time fundraising and more time focusing on their core competencies: serving vulnerable populations in need. Nonprofits would also benefit from increased coordination among organizations working on similar issues, raising their effectiveness. Investors would put capital to work that achieves both meaningful social impact and financial returns. They would also have the opportunity to participate in a new asset class with the benefits of portfolio diversification. Government would attain accountability for taxpayer funds and better results for its citizens at lower public expense, even after paying an appropriate financial return to investors. Most importantly, breaking the cycle of reliance on crisis-driven interventions, wider availability of effective prevention services would benefit vulnerable individuals, families, and communities.
Launching a Social Impact Bond requires a significant effort up front to identify and vet potential programs and then negotiate a contract in which the government agrees to repay investors if the selected nonprofit service providers achieve specified social outcomes. A dedicated SIB intermediary can play a valuable role in these initial stages. After a contract is secured, SIBs would work as follows (see figure 1):

**FIGURE 1 SOCIAL IMPACT BOND MECHANICS**

1. An intermediary issues the SIB and raises capital from private investors.
2. The intermediary transfers the SIB proceeds to nonprofit service providers, which use the funds as working capital to scale evidence-based prevention programs. Throughout the life of the instrument, the intermediary would coordinate all SIB parties, provide operating oversight, direct cash flows, and monitor the investment.
3. By providing effective prevention programs, the nonprofits improve social outcomes and reduce demand for more expensive safety-net services.
4. An independent evaluator determines whether the target outcomes have been achieved according to the terms of the government contract. If they have, the government pays the intermediary a percentage of its savings and retains the rest. If outcomes have not been achieved, the government owes nothing.
5. If the outcomes have been achieved, investors would be repaid their principal and a rate of return. Returns may be structured on a sliding scale: the better the outcomes, the higher the return (up to an agreed cap).

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After the SIB term is complete, the government potentially has two options to extend the program. Theoretically, it could fund the program directly, or it could execute another SIB to fund the program for five to ten more years. Given the considerable value added by the intermediary and the market discipline that investors contribute, SIBs would be an effective way to recapitalize successful programs.

It is important to note that SIBs are intended to complement government funding, and must not be used to displace or replace it. SIBs support proven programs that the government is not currently funding at all or at scale, either due to budget constraints or an unwillingness to assume the financial risk if prevention fails. To expand programs that are already in place, SIBs should supplement existing public funds, transferring the financial risk of program expansion to investors who are prepared to analyze and accept that risk.

INNOVATIVE FEATURES
SIBs differ substantially from traditional vendor contracts and even from performance-based contracts for social services. Most governments pay for social services with insufficient consideration to how effective the programs actually are in achieving better outcomes for the target population. To a limited extent, some governments use performance-based contracts that offer reimbursement or financial incentives and penalties for performance above or below defined thresholds. Yet, these contracts usually require that nonprofits raise their own working capital, with payment from the government occurring only after certain targets have been achieved. But very few nonprofits have the ability to fund, let alone scale, their operations in this way. Also, reimbursement tends to be measured by outputs, rather than outcomes.
These contracts often reward nonprofits based on the number of people who have completed a substance-abuse recovery program, for example, rather than the number who remain sober for an extended period of time or reductions in drug-related crime. SIBs are unique in their up-front provision of working capital to nonprofits and their emphasis on social outcomes.

TO MANAGE THE ASSOCIATED RISKS, AN INTERMEDIARY WILL ENGAGE IN PROJECT MANAGEMENT OVER THE LIFE OF THE INSTRUMENT, MUCH LIKE AN ACTIVE ASSET MANAGER, TO ENSURE THAT LONG-TERM OUTCOMES AND THE COLLECTIVE OBJECTIVES OF ALL THE PARTIES ARE ACHIEVED.

Despite their name, Social Impact Bonds differ from municipal bonds and other fixed-income instruments that are often used for infrastructure or other capital projects. SIBs share features of both debt and equity. The instrument has a fixed term of between five and ten years, and the upside is capped, but, like equity, returns vary based on performance. Compared to a typical debt instrument, investors bear a higher risk of losing all of their principal. Moreover, these investments are not backed by hard assets or cash flows. To manage the associated risks, an intermediary will engage in project management over the life of the instrument, much like an active asset manager, to ensure that long-term outcomes and the collective objectives of all the parties are achieved.

The SIB structure described above, which might be termed SIB 1.0, is flexible and can change over time (see page 15, “Beyond SIB 1.0”). While SIB pilots will likely focus on programs with near-term cost savings, it is possible that SIBs could finance programs that do not necessarily lead to savings or that offer longer-term or more diffuse savings. For instance, preschool programs for low-income children have been shown to be very effective, but their outcomes are manifest years later in the form of better high school graduation rates, improved health outcomes as adults, and lower crime rates. Government could agree to participate in SIBs for such public-sector priorities, despite a lack of sufficient levels of immediate savings to cover program costs. Alternatively, in lieu of government, corporations and foundations could participate as payors. Where corporations (such as health insurers) benefit from SIB programs, they may see an incentive to agree to pay investors if
**BEYOND SIB 1.0**

The first Social Impact Bonds will likely follow a similar structure: philanthropically minded investors providing working capital for nonprofit interventions that generate near-term cost savings the government can share with investors. Over time, the SIB structure is likely to vary and become more flexible. Specifically, variation may occur in four areas:

**Payor:** A foundation or corporation, or a group of either, could agree to pay for outcomes. Foundations may be interested in participating as payor where the government is unlikely to commit. For instance, there are interventions that generate positive outcomes, but their associated cost savings do not cover the cost of the intervention or occur too far in the future to repay investors in the near term. Alternatively, corporations may agree to pay for outcomes if an intervention is beneficial to them. Health insurers, for instance, may find it attractive to participate in an SIB that reduces health claims for a certain population.

**Investors:** While early interest in SIB investment is likely to come from foundations, charitable trusts, high net-worth individuals, and family offices, institutional and other market-rate investors may find SIBs to be an attractive investment opportunity as the instrument gains a track record. As the SIB model is proven and tested in various geographies and diverse issue areas, investors should gain confidence in the instrument’s viability. It is possible, however, that mainstream investors may participate earlier if SIBs are structured in such a way as to decrease the investment’s downside risk.

**Social enterprises:** While attention now is on nonprofits that generate social value and near-term government savings, for-profit social enterprises could become SIB candidates as well. As noted above, interventions that do not produce quantifiable near-term savings may also be considered.

**Investment structure:** In addition to these variations, SIBs will likely move from a deal-by-deal approach to a portfolio approach, allowing investors to diversify their risk by investing in a basket of SIB-funded interventions.
outcomes (such as smoking cessation) are achieved. Foundations could act as payor via performance-based grants on projects that have large societal value, but that produce outcomes that are hard to measure or do not create public-sector savings. The types of SIB investors, the enterprises that are funded, and the structure of the investment are also flexible and subject to variation.

**KEY PLAYERS**

Due to the complex nature of the problems Social Impact Bonds are designed to address, the number of partners involved, and the long duration of the projects they fund, the underlying contractual agreements must support and align the interests of all parties. The key players—nonprofits, investors, government, intermediaries, and evaluators—must reach agreement at the outset and maintain consensus over the life of the instrument. During the SIB, they must engage in coordinated activities in order to achieve the strategic objective of producing greater social impact and reducing public-sector cost. The identification and selection of qualified parties, the allocation of responsibilities among them, and the synchronization of their work are critical success factors.

Although complex, the SIB partnership establishes a system of checks and balances that prevents any single party’s self-interest from undermining the pursuit of shared objectives. The bar is kept high for the targeted social outcomes, providing nonprofits with the incentive to deliver quality services. Government only pays investors for real value creation, encouraging investors to conduct due diligence and follow the investment closely, contributing to the achievement of a successful SIB program. This interdependence promotes productive collaboration, encouraging the parties to focus on real long-term progress.
The characteristics of each player and how they interact are described below.

**NONPROFITS**

SIBs should not be seen as a panacea for every nonprofit’s funding challenges. They are a tool that can work for a certain subset of nonprofits. Since SIBs are best suited to scaling what works, the ideal candidates for SIB funding are nonprofits with programs that have been shown to be effective. Investors will only participate if they have confidence in the nonprofit’s ability to deliver the agreed outcomes. These outcomes, in turn, must translate into government savings that can be achieved within a relatively short time frame and are large enough to cover the program’s cost and a reasonable return to investors. The program must serve a well-defined treatment population that can be tracked and whose outcomes can be measured against a counterfactual over the life of the SIB. Finally, these nonprofits must have the capacity to use growth capital effectively to scale up their programs. Selection of the SIB intervention and nonprofit providers should also involve careful consideration of the target population, and contingency plans should be made to protect vulnerable individuals if the SIB programs fail. One SIB can fund a single nonprofit or several service providers working toward a common goal.

**INVESTORS**

Investors impose market discipline on the partnership. They help drive organizational efficiency by requiring that their financial return be determined through a clear measurement methodology. Since the financial risk is transferred to the investors, they must have sufficient information to price the risk they are undertaking. In order to commit their capital, investors need robust investment propositions in which risks, as well as financial and social returns, are properly articulated and managed. They will require tools, such as a credit scorecard, that reflect an intermediary’s methodical and careful vetting of interventions and rigorous assessment of nonprofit service providers’ ability to scale up their operations.
Robust intermediaries will give investors confidence that the SIB-funded program will be well executed, performance will be tracked regularly, and outcomes will be determined fairly and reliably. Enduring intermediaries will be dedicated over the life of the SIB to mitigate any risks that could affect investor repayment. For instance, the intermediary will reduce the political risk that the government fails to appropriate funds to pay investors by working to secure authorization of a multi-year contract.

SIBs should have bipartisan appeal as they shift financial risk to private investors, impose market discipline, and encourage cross-sector collaboration as well as the efficient use of government funds.

With an informed understanding of the risk involved in the financing, investors can then evaluate whether to invest. SIBs can be structured to attract investors with a wide range of risk appetites, including foundations and the charitable trusts of high-net-worth individuals, as well as institutional investors. A range of structures may be deployed to allow investors to choose the most appropriate risk-return profile.

For example, a structure with senior and subordinated tranches could attract mainstream as well as philanthropic investors. A senior tranche could offer low-risk and fixed returns to institutional investors, while a subordinated tranche funded by philanthropic investors would function as a first-loss reserve. Various credit enhancement techniques may be applied in a single-tranche SIB or in combination with the tranche structure to lower the risk profile of the senior tranche. For example, a minimum amount of guaranteed cash flow, an insurance “wrap” of some or all of the principal payments, or a reserve fund could be offered. All of these would serve to yield greater investor participation and reduce the cost of the overall financing.

**Government**

SIBs require government champions who are committed to effective preventive interventions and collaboration with nonprofits. While SIBs appear to lend themselves to state-level projects (since states assume much of the burden for safety-net spending), they can also work at the local and federal levels. SIBs should have bipartisan appeal as they shift financial risk to private investors, impose market discipline, and encourage cross-sector collaboration as well as the efficient use of government funds.
Governments play a key role in the design and structure of the procurement process for an SIB contract (see page 25, “Government Contracting for Social Impact Bonds”).

**INTERMEDIARIES**
Dedicated intermediaries play a vital role in developing and launching SIBs, as well as managing the ongoing public-private-nonprofit partnership over the life of the instrument. SIB intermediaries can address stumbling blocks encountered during the program, ensuring its successful implementation. In order to keep the project on track, an intermediary might add or replace resources to strengthen an intervention that is not working as expected. The intermediary needs to have a collaborative relationship with evaluators to understand interim results as well as with providers to jointly identify and address problems as they arise. For further discussion on the role of the intermediary, see “Risk Mitigation through Intermediation,” later in this document.

**EVALUATORS**
SIBs require two types of evaluation: a “strategic” or “developmental” approach that provides ongoing feedback on interim performance throughout the lifetime of the SIB as well as a second “summative” approach that provides an audit of whether the pre-defined outcomes have been ultimately achieved. Only the latter must serve an independent auditing function, although the former would benefit from third-party expertise.

Randomized-controlled trials are too expensive, cumbersome, and often logistically infeasible for the second type of SIB evaluation, but quasi-experimental evaluation designs (in which the treatment group can be compared against a matched comparison group) should be practicable. Special care should be taken to design an evaluation that avoids creating perverse incentives, such as serving the easiest or most motivated clients.
(“cream-skimming”), and other unintended consequences. For instance, the U.K. SIB tracks all ex-offenders leaving Peterborough prison, not just those who elect to participate in the reentry program. Outcome measurements are reflective of the wider population, rather than of just those who may be more motivated to seek these services. In addition, to the greatest extent possible, both evaluation processes should be geared to support rather than burden nonprofit operations.

SIB evaluation requires a robust data collection system to track program participants and their outcomes over time. While effective nonprofits may have their own data systems, it is advisable that an SIB intermediary, with an evaluator, perform due diligence up front to assess any gaps and weaknesses in data-collection protocols. Collaboration with relevant government agencies will also be necessary to gain access to administrative data, such as Medicaid records. Administrative data will allow evaluators to assess program participants’ outcomes relative to a comparison group or a historical baseline. Where programs affect multiple government agencies, integrated data systems would be extremely beneficial. For instance, youth aging out of foster care can affect the criminal justice, health, housing, and welfare systems. A data system that tabulates costs and savings across these agencies would facilitate the measurement of outcomes.

POTENTIAL RISKS
The Social Impact Bond model is not without its risks. A multi-party, cross-sector initiative introduces complexities that traditional government-vendor contracts do not entail. SIBs present risks that may include, but are not limited to, intervention model, execution, intermediary, political, financial, and reputational risks.

INTERVENTION MODEL RISK
If the selected intervention is not carefully vetted, it may fail to produce the expected social outcomes. The due diligence process should provide an understanding of the intervention model, project cash flows, and the capacity of the nonprofit providers. This step is critical to an SIB’s success.

STAKEHOLDERS MUST MAKE PROVISIONS TO ENSURE THAT NO HARM COMES TO THE TARGET BENEFICIARIES IF THE PROJECT FUNDED BY THE SIB OR THE SIB ITSELF DOES NOT SUCCEED.
EXECUTION RISK
SIBs face not only the usual performance challenges that any project-based financing entails, but also ones that arise from the unique vulnerabilities inherent in its operating model. Problems can occur if there are unclear lines of authority, poor communication among multiple participants, lack of follow-through by one or more partners, or failure to capture timely and reliable data on progress. In addition, SIBs impose significant managerial, performance, and measurement burdens on nonprofit organizations. SIBs may encounter problems if nonprofits lack sufficient capacity to manage these responsibilities when scaling their programs. Stakeholders must make provisions to ensure that no harm comes to the target beneficiaries if the project funded by the SIB or the SIB itself does not succeed.

INTERMEDIARY RISK
Intermediaries must be enduring to add value to SIBs from deal origination through investor repayment. They are required to raise the capital, administer its deployment, and price and manage the risks inherent in an SIB proposition. Intermediaries that fail to commit to SIBs over the long term, either due to changing internal priorities or weak financials or governance, expose SIBs to greater risk. Ideally, intermediaries will have multi-disciplinary knowledge across the financial, governmental, and social sectors, and strong working relationships with evaluation firms and subject-matter experts. Intermediaries lacking this background and these relationships contribute greater risk to a successful SIB.

POLITICAL RISK
It is possible that the government could fail to repay investors even when the pre-defined outcomes are achieved. In recognition of this possibility, investors will require a secure obligation from government to pay agreed-upon returns under unambiguous terms and conditions. Ideally, SIB repayments should not be subject to the political uncertainty inherent in the annual appropriations process. Investors would be reluctant to commit capital for five or more years if the government can only guarantee funding for one year at a time. Government credit risk, the risk that even with these arrangements governments will fail to meet their obligations to investors, should also be considered.
SIBs signify a new paradigm of public-private partnerships in the wake of the financial crisis, one that privatizes the risks and shares the gains.

***Financial Risk***

As described above, investors bear 100 percent of the financial risk in an SIB. This instrument allows government to only pay for those programs that are successful. Unlike some pay-for-performance contracts, nonprofits are provided with up-front funding over the duration of the SIB. SIBs signify a new paradigm of public-private partnerships in the wake of the financial crisis, one that privatizes the risks and shares the gains. Risk-mitigation methods (such as first-loss provisions, reserve funds, or other credit-enhancement products) could be incorporated into the SIB structure to allow the SIB to appeal to a wide range of investors.

***Reputational Risk***

If an SIB-funded intervention is unsuccessful, the nonprofits carrying out the program may suffer significant reputational harm. Their failure to achieve target social outcomes will likely affect donors’ decisions about funding these organizations in the future. Similarly, if the government fails to repay investors despite the achievement of agreed-upon targets, it too can suffer damage to its reputation and its credit rating.

***Risk Mitigation Through Intermediation***

Dedicated intermediaries play an essential risk-management role in the Social Impact Bond model. Vertically integrated third-party intermediaries that are actively involved throughout the entire SIB value chain—from deal origination through investor repayment—are likely best suited to ensuring successful outcomes.
Intermediaries could be involved in the following phases of SIB development and implementation (see figure 2):

**ORIGINATE DEAL**
Intermediaries identify social issue areas with savings opportunities in which there appear to be significant net benefits that could be realized over a reasonable time horizon. They meet with government officials to learn of their priority issues and find areas of mutual interest. Intermediaries identify and conduct careful due diligence regarding potential nonprofit providers. They also conduct financial modeling to assess the viability of each SIB application. Through these activities, the intermediary reduces intervention model risk.

**SECURE GOVERNMENT CONTRACT**
Unlike traditional government contracts in which taxpayers directly fund operations, SIB contracts require more collaborative approaches to develop an arrangement that promotes long-term outcomes. The process of contracting for an SIB can take different forms. Whether it is a competitive procurement process or direct negotiation between an intermediary and government agency, it will be imperative for SIB contracts to carefully lay out the parties’ shared expectations about the objectives and the means of achieving them (see page 25, “Government Contracting for Social Impact Bonds”). Once a contract is in place, or as it nears its final form, the parties must work together to secure legislative authorization of the contract supporting the SIB in order to provide investors with confidence in repayment and lessen the political risk.
STRUCTURE INSTRUMENT
Once awarded a government contract, dedicated intermediaries finalize the cash flow model, data requirements, evaluation strategy, and operating plan. They also structure investor term sheets, reflecting an understanding of the needs of different investors. As mentioned earlier, credit enhancement strategies and different capital structures could be undertaken to encourage the participation of additional types of investors.

RAISE CAPITAL
Intermediaries recruit interested investors, raise the investment capital, and issue the bonds. Once an SIB is launched, intermediaries call capital and disburse payments to service providers. They also serve an investor-relations role by monitoring the financial and social metrics of SIBs and ensuring that investors receive regular investor communications on program performance.

MANAGE PROJECT OVER INSTRUMENT'S LIFE
Perhaps an intermediary’s most important long-term role is overseeing the SIB-funded program from inception through final investor repayment. This project-management role is essential to the success of the SIB. Intermediaries help nonprofits absorb and deploy SIB proceeds to maximize impact. They also facilitate nonprofits’ coordination with government partners, the community, and other service providers, promoting collaboration within the social sector. By making mid-course corrections and filling resource gaps as necessary, intermediaries mitigate execution risk and enable nonprofits to focus their time and resources on their core competencies. In addition, they see to it that evaluation efforts run smoothly and inform program progress along the way. Knowing that an intermediary will be looking out for hurdles and helping to address them should provide investors with greater confidence in SIBs.
If states choose to pursue competitive solicitations during this early stage of SIB development, procuring and developing SIB contracts will be challenging for two reasons. First, no one in the U.S.—government agency, intermediary, nonprofit, or investor—has ever executed such an agreement. They would differ from traditional government-vendor contracts or even contracts with financial incentives and penalties. Second, at this nascent stage of the market, only a very few organizations are qualified to serve as SIB intermediaries, particularly when it comes to raising investment capital and providing long-term project management.

State procurement laws establish a strong presumption in favor of competitive solicitations, based on two assumptions that might not be justified in the case of SIBs: that there are numerous qualified firms in the market and that standard contract terms and conditions can be prescribed in detail to establish a “level playing field” for all respondents. But SIB contracts involve an unusual number of unfamiliar moving parts. The world’s first SIB Request for Proposals, issued by the Treasury Department of New South Wales, Australia, demonstrates this point. The document asks respondents to include information about the target population, location of the intervention, program referrals, evaluation, payment triggers, and cash flows in different performance scenarios, as well as numerous other details of the intervention and investment structure.

State procurement professionals and legal counsel may want to consider whether there are ways to structure solicitations with due regard for the small number of qualified intermediaries and the fact that initial contracts will be limited to demonstration projects. For example, the range of prospective responders could be identified through a Request for Qualifications that describes the extent to which the state wishes to engage either a specialized or full-service intermediary. Alternatively, a more iterative process could be used to develop a flexible contract that leverages the capabilities of non-governmental organizations.
Promising Initial Social Impact Bond Applications

SIBs hold great promise in addressing a range of issue areas in various geographies. The following vulnerable populations could be served by SIB-funded interventions (see table 2):

<table>
<thead>
<tr>
<th>VULNERABLE POPULATION</th>
<th>INTERVENTION MODEL</th>
<th>RETURN ON INVESTMENT</th>
<th>POTENTIAL AGENCY SAVINGS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Churally Homeless Individuals</strong></td>
<td>Permanent supportive housing</td>
<td>Decreased use of acute medical care, shelter, &amp; incarceration</td>
<td>Medicaid, Corrections, Housing</td>
</tr>
<tr>
<td><strong>Juvenile and Adult Offenders</strong></td>
<td>Community-based alternatives &amp; reentry programs</td>
<td>Avoided facilities expense &amp; lower recidivism rates</td>
<td>Youth Services, Corrections, Probation, &amp; Parole</td>
</tr>
<tr>
<td><strong>Low-income Seniors</strong></td>
<td>Aging-in-place via supportive housing</td>
<td>Reduced nursing home stays</td>
<td>Medicaid, Medicare</td>
</tr>
</tbody>
</table>
CHRONICALLY HOMELESS INDIVIDUALS
In 2011, there were approximately 110,000 chronically homeless individuals across the United States. Many of them have been on the streets for long stretches of time and have at least one disabling condition, such as a mental illness, substance addiction, or physical handicap. They impose substantial costs on public systems, as they make frequent use of emergency rooms, mental health and substance abuse facilities, jails, and shelters. Permanent supportive housing (PSH), which is affordable housing with access to services such as case management and behavioral health care, has been shown to be enormously effective with this population. PSH encourages residential stability, improves health and management of chronic illness, and decreases the use of safety-net services. (See page 28, “Example: A Social Impact Bond to End Homelessness” for an illustration of SIB economics for this intervention.)

COMMUNITY-BASED ALTERNATIVES TO LOCKED FACILITIES, AS WELL AS ADULT REENTRY PROGRAMS, SHOW PROMISE IN LOWERING RE-OFFENDING RATES AND FACILITATING BETTER OUTCOMES.

JUVENILE AND ADULT OFFENDERS
States spend more than $50 billion a year on corrections. The exploding cost of criminal justice has led some governments to shift funds away from education and other critical public investments just to keep offenders locked up. Meanwhile, detaining and incarcerating juvenile and adult offenders who do not pose clear public safety risks has no beneficial effect on either population, as evidenced by high recidivism rates across the country. In particular, juvenile detention can be highly detrimental to at-risk youth, as it disrupts their education, separates them from their families and communities, and exposes them to high-risk peers. Community-based alternatives to locked facilities, as well as adult reentry programs, show promise in lowering re-offending rates and facilitating better outcomes.


**EXAMPLE: A SOCIAL IMPACT BOND TO END HOMELESSNESS**

To illustrate how SIBs work, consider a fictional SIB designed to address chronic homelessness. Chronically homeless individuals impose substantial costs on taxpayers as they cycle in and out of emergency rooms, jails, and shelters. Permanent supportive housing (PSH) has been shown to be enormously effective with this population, improving outcomes and greatly reducing costs to the public. This holistic strategy combines affordable housing with access to services such as case management and behavioral health care.

Before PSH is provided, assume that a state’s population of chronically homeless people imposes costs of $100 million. After PSH is made available, these costs go down substantially, but this population still needs health care and may actually access more outpatient, preventative care. Assume these costs are now $25 million. The SIB would raise $40 million to cover the cost of supportive housing (as well as non-programmatic SIB costs such as evaluation and project management). The government would then use a portion of its $35 million in net savings ($100 million minus $25 million minus $40 million) to fund investor returns, retaining the remainder.

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5 The numbers used in this example are for illustrative purposes only and are not meant to represent a specific SIB.
LOW-INCOME SENIOR CITIZENS
Seniors are a growing demographic nationwide, now accounting for 13 percent of the total U.S. population and projected to increase to 20 percent by 2050. As life expectancy grows, there will be greater numbers of seniors coping with frailty and reduced mobility. When they can no longer live independently, many seniors must enter costly nursing facilities, even if they need acute care only for a short time. Low-income seniors who move into these facilities and who are eligible for both Medicaid and Medicare impose significant costs on the government. Yet numerous alternative services can provide the extra care seniors need at much lower cost than nursing homes while allowing seniors to remain in their own homes or communities. Such “aging-in-place” interventions facilitate healthy outcomes while generating government savings.

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PETERBOROUGH ONE YEAR ON

While it is too soon to tell whether the Peterborough Social Impact Bond program, the One*Service, has reduced reoffending enough to generate a return to investors, indications are encouraging.

The One*Service has made progress in finding housing, accessing health care, and increasing the income of prisoners leaving Peterborough prison, even those facing some of the most complex social challenges. While engagement with the One*Service is purely voluntary, the proportion of prisoners it is working with is encouragingly high, indicating clear evidence of an unmet need. Clients are reporting better control of their lives and lower reoffending rates, a finding that has been corroborated by local police. Key to the One*Service’s success is the flexibility inherent in its financing, which can be targeted as necessary to provide tailored services to clients.

Real-time program assessment and adjustment have also been critical to ensuring that the One*Service is meeting prisoners’ needs. The program providers, for instance, found that prisoners who initially refused support often ended up needing the One*Service when their original plans fell through.

So far, the Peterborough model has successfully replaced a one-size-fits-all approach with a targeted model to treat a vulnerable population. Whereas prior funding for reentry programs was piecemeal and short-term, the SIB provides long-term, flexible funding streams. It makes productive use of evaluation, which occurs far too infrequently in the social sector, and encourages coordination among local providers delivering complementary services, maximizing efforts around the achievement of shared objectives and positive social outcomes.
Conclusion

Social Impact Bonds offer an innovative way to scale what works. If they work as hoped, proven innovations will no longer languish for years as service providers struggle to access the capital needed to complement the limited funds currently available from government and philanthropy. Investors will have the opportunity to invest in a new product that allows them to fund solutions to major social problems, such as homelessness, in a way that was not available to them ever before. Government will be able to shift resources from costly remediation programs to more efficient prevention services. Most importantly, greater numbers of low-income and at-risk individuals and families will participate in effective programs that help them before problems become acute, stemming the increasingly unsustainable need for crisis-driven services.

If the market grows, SIBs may also influence larger shifts within the nonprofit, government, and investing communities. This new source of capital, which relies on demonstrated results, will encourage nonprofits to develop robust data collection methods, create performance metrics, and measure social outcomes. With greater market discipline and transparency within the social sector, governments will have access to
better data that enable rigorous assessment of various program alternatives and inform responsible public investment. In addition, governments may begin to measure success using outcomes rather than outputs, driving greater accountability within the public sector. SIBs will also promote the transition from siloed government programs to broader thinking about how interventions in one area, such as housing, affect outcomes in another, like health care. Cross-agency collaboration will encourage better use of public resources and possibly advance new solutions to some of society’s most pervasive and intractable problems. Lastly, SIBs may influence the creation of additional impact investing products that similarly monetize social outcomes to calculate investor repayment and returns.

While not a panacea, SIBs hold the promise of becoming a multi-billion dollar source of growth capital for the social sector. Although it is still early in their implementation, SIBs are poised to mobilize investment capital to advance social progress and create better outcomes for target beneficiaries. Conducting SIB pilots across issue areas and geographies will be essential in broadening our understanding of how they can be implemented most effectively.
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Social Finance is a vertically integrated Social Impact Bond intermediary dedicated to launching high-quality Social Impact Bonds in the U.S. Independently funded and managed, Social Finance leverages the innovative work of its U.K.-based sister firm, Social Finance, Ltd., which pioneered the concept of the Social Impact Bond and offered the first one in September 2010 with the goal of reducing prison recidivism.

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