

Social Impact Bonds: A Practical Social Innovation

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The Social Impact Bond (SIB) is gaining global attention as a financial instrument that provides a new way to tackle social issues.¹ Not only are SIBs attracting interest in impact investment circles, that is, among investors who seek social and/or environmental benefits as well as financial gain, but through a daily dose of updates on social media like Twitter and global blogs, the SIB buzz is making its way to government officials and the non-profit sector. Initial conversations with these communities are characterized by both curiosity and confusion (sometimes at the same time), which leaves many wondering what effect the SIB model could have on social issues in Canada, or more specifically, what impact it could have on the way governments and foundations commission outcome-based contracts in the future.

Innovation in tackling social challenges is the imperative of our time. As noted by Tim Brodhead of the J.W. McConnell Family Foundation, Canada's community sector is poised for transformation in pursuit of such innovations.² With new information and communications technologies that provide powerful tools to expand its reach, the community sector is looking beyond its role of providing services to vulnerable groups to test new approaches to meet emerging needs. It has assets in the form of know-how, commitment, and a generation of enterprising young people willing and able to draw from the worlds of commerce, public policy, and community engagement to make a positive difference.

Although Canada's community sector is vibrant³ and its culture is strong, most organizations within the sector lack the supports and capital to allow their efforts to achieve scale and impact. A strong "contract culture" has created a box of misdirected and overly onerous accountability, making it difficult to explore innovative approaches and cross-sectoral solutions. Social finance, an approach that promotes entrepreneurial models to address social challenges, is one way the sector is looking to diversify its capital sources and bridge the divide with other sectors. But the sector needs a modern enabling environment to get there.

Although the social finance movement in Canada has deep roots,⁴ it has been stalled by limited infrastructure and uncoordinated participation by governments, foundations, and private funds. Governments make significant contributions to the community investing aspect of the social finance market,⁵ but fail to leverage their assets to attract private capital for social enterprise.⁶ One reason for this has been a lack of opportunities for private capital participation, but also because collaboration with government, especially around social issues, remains largely unachieved. The SIB is a social innovation that connects interests and aligns the incentives motivating the three sectors of our social economy. An SIB is a means for public, private, and non-profit sectors to collaborate around a shared objective – in this case, enhanced social outcomes.

What is an SIB?

The SIB is not a debt security. It is a partnership agreement between government, private investors, and agencies providing social services (non-profit, charities, and social enterprises). The mechanism looks and acts more like an equity investment – investors are banking on agencies meeting social outcome targets to realize a return on investment. The return is derived from the cost savings to government, which would be funding the treatment of the social issue if the contract was not in place.

Here is an example (for illustrative purposes only)⁷:

To tackle the high rates of Aboriginal unemployment in Canada, private investors (foundations, financial institutions, and individuals) agree to invest in agencies that train, mentor, and match Aboriginals seeking employment in local businesses. The federal government has shown commitment to this outcome in the past. It has created 2,185 jobs in the last six years with \$465 million in funding for the Aboriginal Skills and Employment Partnership program, and the Aboriginal Skills and Training Strategic Investment Fund (Treasury Board of Canada, 2008).⁸ One barrier to higher placement rates, however, has been accommodating individuals with low levels of education.

An SIB Delivery Agency (an intermediary), acting on behalf of the entire group of stakeholders, designs an employment strategy and drafts the partnership contract. This entails estimating potential cost savings to government partners, returns to investors, and social benefits to clients. The Delivery Agency negotiates a rate of return on invested capital (based on anticipated social outcomes and cost savings) with the government partners and enters into contracts (on behalf of investors) with service agency(ies) to meet these targets.

Investors and the government have relative confidence that this innovative approach focusing on education will result in an increased rate of employment, and will save public funds (a portion of the current cost per job placement in existing programs), in addition to the other economic and social benefits of employment.

The government agrees to pay a risk-adjusted return to investors (say 7.5%) from the (potential) cost savings to the public – calculated as a portion of cost savings to the government multiplied by the target number of new jobs.

Using this example, the strengths of the model are highlighted:

1. **Risk is lowered for government while innovative programming is empowered.** Typically governments intervene when markets fail, usually leading to the treatment of downstream symptoms rather than upstream prevention (early in the project). Prevention is risky as its outcome has increased variability and its results have longer-term realization timelines. In the example, private investment absorbs the cost if the education program fails, and the government partners pay only if the desired social outcomes are achieved.
2. **The model encourages scaling of a successful intervention.** A cohort of social service agencies, aligned in an intervention strategy according to their specific strengths, receives funding at the start of the intervention to achieve the social targets. This provides incentives for strategic planning, building internal capacities, and creating and sharing knowledge to support what works.
3. **The model develops a market for a social outcome with private investment.** Although the model hinges on a number of agreements between stakeholders facilitated through an intermediary, the underlying financial risk is with investors (not government) who rely on service agencies with a track record of success to meet the social outcome targets. This establishes a new accountability framework around social objectives, giving governments the opportunity to enable positive change rather than respond to crisis or failure. The benefits to clients are paramount and the incentives (for service providers and investors, through to governments) to realize these benefits are completely aligned.

SIBs for Targeted (not Universal) Purposes

The SIB model is not designed to apply to all social issues. The community sector addresses a broad range of social and environmental problems, and is particularly effective in meeting the needs of vulnerable populations. There always will be a need

for agencies providing government-funded services in social areas of mental and physical health, housing, climate change, and pollution. Governments will always need to respond in areas of unemployment/welfare assistance, disaster recovery, security, and defence, for example. But, governments' capacity to provide the public goods that we have come to rely on is challenged in a context where the rising costs of health care, supports for an aging demographic, and global warming collide with constraints on government spending.

The SIB model has the potential to be a complementary form of finance, as opposed to a substitute, in areas where prevention could lead to cost savings and increased social benefits. Just as program grants will always have a role funding the sector, existing downstream supports will need to keep pace with the complexity of our social ills.

There are fundamental criteria that help to distinguish the utility of one SIB issue area from another. Not all issue areas will be conducive to a bond. In addition, each criterion will likely hold more weight depending on the perspective of each stakeholder involved in the evaluation of an opportunity. The following are the key considerations:

- *Is the issue a target priority area?* The objective is not to rate or rank social issues, but government, taxpayers, and investors must all agree that the issue has significant social policy implications and that the potential benefits warrant new interventions. There must also be an understanding that a multi-stakeholder, collaborative approach is needed to tackle the issue effectively.
- *Is the population within this priority area well defined?* For example, if youth diabetes is the issue, the number of youth (ages 8 to 18) with diabetes must be statistically relevant and controllable to organize an intervention.
- *Does the intervention strategy have evidence-based success?* Investors and government must understand the logic behind the intervention, a reliable estimate of the costs to meet outcome targets, and have relative confidence that the approach will work. The model is intended to support success in an effort to increase social benefits, not create a way for investors to turn a quick profit from a social ill.
- *Is there an outcome metric?* All stakeholders will need to agree on a simple, easily measureable metric that captures both the social benefit and the cost-saving performance, and can act as the foundation of agreement between them. To evaluate progress, the metric must have baseline data. The significance of this metric cannot be understated as the outcomes (both financial and social) rely on its careful measurement, tracking, and reporting. In any SIB agreement, adequate assistance must be given to social service providers to build measurement capacity.

- *Is there a cost-saving opportunity?* The intervention must cost less than public-sector savings within the contract period. Government must realize cost-savings to be able to provide a return for future budgets.
- *What are the other associated risks?* Risk must be evaluated from the perspective of each stakeholder. What are the risks associated with an innovative approach? What happens if the intervention fails? Are there perverse incentives or negative unintended results that could affect results?

Where Could the SIB Have Applicability?

Social Finance Ltd. has demonstrated that an SIB partnership is a viable option in the impact investing space in the U.K. The first SIB, a six-year pilot to reduce prison recidivism, was announced in the spring of 2010. Currently, two organizations have been funded to reduce the re-offending rates of male prisoners leaving the Peterborough prison after serving short sentences. Research has determined that for every £1 spent on prevention, £10 is saved in costs (Frontier Economics, 2009). So, the Ministry of Justice has agreed to provide a tiered return to SIB investors if re-offending in a 3,000-person cohort is reduced by at least 7.5%, with returns capped at a maximum of 13%.

Social Finance has raised £4.9 million of private investment (mostly from foundations and trusts) to design an integrated strategy, with inter-locking delivery of program activities (i.e. mentoring, counselling, job support, etc.) for each participating agency. If these programs are successful in achieving the social objectives, investors will be paid out in years 4, 6, and 8 after a baseline is established and the program has results to measure.

Besides recidivism and Aboriginal employment, immigrant settlement also may provide an opportunity for application of an SIB.

Citizenship and Immigration Canada, through the Immigrant Settlement and Adaptation Program (ISAP), funds agencies that provide orientation, counselling, and employment services to help immigrants integrate into Canadian culture. The program is a much needed service to newcomers, but documented barriers – insufficient human and financial resources, programming that is unresponsive to evolving needs to clients, and lack of program promotion – prevent the initiative from achieving its stated social objectives. With more than 250,000 immigrants annually and over a half a billion dollars in funding allocated to serve this population, the model may be of interest to both the government and agencies.

An SIB pilot focussed on a specific demographic of new immigrants might serve these purposes:

- New capital in the system will augment what is currently being offered.
- Up-front funding will give agencies the financial means to build the capacity of their teams to best serve their clients. If their clients' needs change, the funding allows the flexibility to adapt the program to meet the objectives.
- Government, investors, and service agencies all have the incentive to pursue the most practical means of achieving the social objectives because of the monetary rewards baked into the model.

Other areas that have been discussed as potential SIB opportunities in Canada, or globally, include: tackling skyrocketing rates of diabetes; lowering demand for power generation; reducing hypertension; reducing respiratory disease; developing more effective drug rehabilitation projects; reducing the persistence of mental health diseases; or improving the supports for adults with developmental disabilities. As the list continues to grow, the importance of clarifying the issues becomes more pressing.

As we move forward in the exploration of this emerging model, I offer a few cautions to help guide internal SIB discussions and further clarify the opportunity ahead of us:

- Not all social issues are SIB issues
 - A good first check to help determine whether the model may have applicability is to use the above-mentioned six criteria. The ultimate goal is to improve social outcomes – until we figure out how to do that (and measure it), the innovative model will have limited take-up
 - Another important consideration is whether or not the intervention will serve those areas at odds with the current system or address those that are easily supported. The objective is systemic change to many, not short-term benefits for a few
- All levels of government are facing fiscal challenges that limit the availability of resources (both human and financial) to explore social innovation
 - Governments have strong public and private connections that could be tapped to form a working group to research and develop pilot programs. Social enterprise can also initiate this research on SIB feasibility and open discussions with governments and other partners about how they could provide support
- Private capital is key
 - In the U.K. model, there is a cap set on possible investment returns – 13% adjusted annually. Though not an open-ended money-making scheme, potential SIB returns must also signal to commercial investors a viable opportunity to generate reasonable returns in order to attract additional investment. A careful discussion needs to take place when setting financial limitations on the model.

- Benefits (social and financial) have the potential to accrue across government departments
 - Departments need to agree on metrics and measurement approaches, baseline data, outcome targets, and the delegation of responsibility for performance payments. It is likely that benefits will be realized at provincial and federal levels of government. Careful consideration also must be given to how the outcome payments will be provided over the life of the project (which may extend over five to seven fiscal years).
- What happens if an SIB works?
 - One of the key objectives of the model is to provide sustainable funding for interventions that work. If the approach is successful in enhancing outcomes, service delivery organizations will need new sources of capital once the partnership contract ends. There are a variety of scenarios that could be explored after a successful pilot: governments could fund the intervention themselves; they could pursue another SIB partnership; or they could do both – use public funds to pay for services to maintain the improvement in outcomes that has been achieved, and raise a second SIB to fund further or related improvement (Bolton, 2010).

Moving Forward

The SIB model is emerging and discussions are taking place in different pockets of the world about how best to proceed. Unfortunately in Canada, where the marketplace for social finance approaches is less developed,⁹ there is a noticeable void, a missing middle. We lack dedicated intermediaries with the mandate to explore innovative approaches, such as the SIB.

As we begin to brainstorm about ways to make this work or to challenge the underpinning assumptions, we must think about practical ways to enable exploration. Who is best positioned to see this through? Should this be driven from government or cultivated at a grassroots level? What is the role of government in a hybrid space? The SIB model is just one example of how we can move the discussion about cross-sector collaboration and build our social innovation ecosystem.

References

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Notes

¹ The model was introduced to a global audience by a panel at the 2010 Social Capital Markets Conference in San Francisco in October.

² Brodhead, Tim, unpublished memo to the Task Force on Social Finance, 2010.

³ There are more than 161,000 registered charities and not-for-profit organizations in Canada. They employ about 2 million people, or 7.2% of Canada's labour force, and generate about \$147 billion in revenue, 43% of which is from fees and the sale of goods and services. This information comes from SiG Memorandum Community Enterprise and Innovation, 2010.

⁴ The Canadian Alternative Investment Cooperative has been making loans to support positive social change for more than 25 years; and Renewal Partners has been investing in social businesses for more than 15 years, not to mention decades of co-operative investment in community economic development.

⁵ It is estimated that they contribute \$1.2 billion annually to intermediaries serving rural communities (about 50% toward economic development).

⁶ Global capital markets have in excess of \$300 trillion at any given time, which doesn't currently take into consideration social impact.

⁷ This model has been simplified. The economic costs and benefits of unemployment have many variables that are not considered in this example.

⁸ According to [Treasury Board of Canada](#) statistics on the Aboriginal Skills and Employment Partnership (ASEP) program for 2007-2009.

⁹ In the fall of 2010, Social Innovation Generation supported the launch of a Task Force on Social Finance to explore key levers to unleash new capital, develop new infrastructure and intermediaries, and build the pipeline of entrepreneurial ventures with social and/or environmental impact.

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