Social Impact Bonds

Social impact bonds (SIBs)[1] are promoted as the latest public-private financing tool that cash-strapped state and local governments should consider to fund and deliver public services. As with other outsourcing, public-private partnerships (P3s), and alternative financing schemes, the reality of SIBs as a funding mechanism does not live up to the hype.

What are SIBs?

SIBs are not bonds where an investor loans money to a bond issuer and is repaid on a set schedule with an agreed interest rate. SIBs are complex multi-stakeholder loans between government, investors, intermediaries and service providers. Investors, private and philanthropic, provide funding for service delivery and the government repays with interest if pre-determined social outcomes are met. If outcomes exceed certain levels, investors may reap even higher returns. Proponents claim that the savings achieved from long-term cost avoidance can be used to pay back the loan.

Instead of a direct contract between government and investors, the SIB adds layers of administration and raises the costs of managing the loan. An intermediary, sometimes an existing non-profit organization or a separate entity created solely for the SIB, acts as a middleman between the government, investors and service providers. Typically, the intermediary hires/selects and manages the service providers, who deliver the intervention or service to a target population. Sometimes the intermediary may work with government entities to also attract investors to the SIB.[2]

A third-party evaluator assesses if pre-determined outcomes have been met to determine success. The gold standard in program evaluation is to randomly split the target population into a control group that does not receive the intervention and a variable group that does and compare the two groups, Other common techniques lack random assignment, such as comparing the variable group to a historical baseline or to a group that looks like the variable group.

Taking a Closer Look at Social Impact Bonds

1. SIBs are not "costless" to the government or taxpayers.

Governments remain responsible for fixed costs, such as contract development and monitoring, review and assessment of the regulatory environment, compliance with any requirements of federal funding, as well as those in the SIB contract, and possibly securing an independent auditor. The Kennedy School of Government at Harvard University, a leading proponent of SIBs, asserts that, "[i]n most cases, these costs are only worth incurring for a SIB contract worth at least $20 million."[3] Yet, most SIBs in practice and in development are below $20 million.

[1] SIBs are also known as Pay For Success (PFS) contracts, performance bonds, social impact loans, and impact investing.
[2] Other models could exist, but this arrangement is predominant in the United States.
[3] *Social Impact Bonds: Lessons Learned So Far*, John F. Kennedy School of Government, Harvard University.

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There is also a chance that the SIB will be terminated early. In Massachusetts, investors have an early termination clause that allows them to cancel the program after two years if it is not performing well, leaving the nonprofit provider and program participants in the lurch. In the United Kingdom, the very first SIB in Peterborough was terminated early because a policy change left no control group to establish performance. The government would incur significant startup costs designing and executing the contract only to have the program cancelled. A study by Maryland's Department of Legislative Services concluded that such SIBs "cannot be justified by offsetting savings."[4]

Policymakers must also consider what happens if the SIB fails, which is what happened with the nation's first SIB at Rikers Island. Far from a success, the public is left to wonder why an intervention with an evidence base of success and enough flexibility to accommodate the constantly changing population on Rikers failed to have any impact on recidivism. Could an otherwise good intervention have failed because of poor implementation by the contractor? Could Rikers have been the wrong setting? What we did learn from this experiment is that investors get to walk away and possibly write it off, but society and government are still left to grapple with serious challenges facing young men in New York City.

2. SIBs are not a source of new capital for programs.

Appropriating funds for SIBs may well displace funding for other programs. A 2013 study by Hawaii's Department of Budget and Finance on the feasibility of SIBs to fund early learning programs found that "SIBs do not create new monies … The authorizing language enacted in Massachusetts gave full faith and credit authority to SIB payments and established a sinking fund by which the Legislature would steadily fund the payments over the life of the contract rather than requiring a future appropriation."[5] SIBs in New York City and the U.K. also require pre-funding potential outcome payments. Given the start-up costs, using a SIB instead of direct financing will place even greater pressure on budgets. In Massachusetts, the state is liable for a minimum of $21 million in payments. Investors, in contrast, are providing only $12 million in funding.[6] Consequently, if an intervention is successful, government must determine how it will continue to fund it, as well as repay the original loan.

3. SIBs will not pay for themselves.

Even using an optimistic model, where a program produces positive outcomes at the higher end of what has been observed so far and has very low design, implementation and evaluation costs, Maryland found that "a 10 percent reduction of re-imprisonment for program participants would at best produce a 6 percent discount to the total cost of operating the pilot program." According to the researchers commissioned by the UK to evaluate the Peterborough SIB, "[t]he Peterborough SIB is too small to deliver substantial 'cashable' savings (monetized benefits)."[7] Even the Kennedy School of Government states that, "[i]nitial discussions have focused on initiatives that could yield budgetary savings that fully cover program costs, but most socially beneficial interventions are unable to meet this standard."[8]

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[4] *Evaluating Social Impact Bonds as a New Reentry Financing Mechanism: A Case Study on Reentry Programming in Maryland*, Maryland Department of Legislative Services.

[5] *Study on the Feasibility of Using Social Impact Bonds to Fund Early Learning Programs*, Hawaii Department of Budget and Finance.

[6] *Fact Sheet: The Massachusetts Juvenile Justice Pay For Success Initiative,* Goldman Sachs.

[7] *Lessons learned from the planning and early implementation of the Social Impact Bond at HMP Peterborough*, RAND Europe.

[8] *Social Impact Bonds: Lessons Learned So Far*, John F. Kennedy School of Government, Harvard University.

As noted by the consulting group, McKinsey & Company, "SIBs are a more expensive way to finance the scaling up for preventive programs than if the government simply went to service providers and paid them to expand an intervention to more constituents."[9] Martin Brookes, chief executive of the Paul Hamlyn Foundation in the U.K. and one of the original funders of the Peterborough social impact bond, pointed out that transactions have been "incredibly expensive to put together" and demand for them among investors is "very questionable." He added that "the hype about social investment massively eclipses the reality."[10] Some wonder why governments would not simply issue regular bonds to generate program funds since they are quite likely to be far less expensive than SIBs in the long run.[11]

4. In fact, governments could get gamed.

At a May 2014 U.S. Senate Budget Committee hearing, Senator Angus King commented that SIBs sound like a "fancy way of contracting out" and detailed the accompanying challenges that governments already face with such contract development, execution and monitoring.[12] Kyle McKay testified that "[a]ttempting to manage social services through contract attorneys, consultants, financial intermediaries and an all-or-nothing payment model based on an evaluation will inevitably produce a contract that is complex and subject to unforeseen contingencies and weaknesses."

One of the most technically complex issues with SIBs is how to measure the impact fairly. Governments and stakeholders have to be confident that the measurement tools can demonstrate a direct causal link that is statistically significant between the SIB-funded intervention and outcomes. In other words, SIBs need to show that the results are due to the intervention and not to chance. Yet, the target populations of SIB-funded interventions are likely to already receive public support or participate in other interventions. Unless everything remains the same, isolating the impact of the SIB-funded intervention is not a straightforward exercise. For example, it remains to be seen how evaluators of the Chicago pre-K SIB will adjust for the effects of some low-income children attending a full-day pre-K, when the SIB is evaluating the efficacy of attending a half-day pre-K program.

Providers and investors will be motivated to avoid losing money on SIBs. Tying high stakes to outcome-based performance measures creates disincentives to serve the neediest populations ("creaming"). It creates incentives to skew services to focus on selected outcomes at the expense of other aspects of a program ("tunnel vision") and it results in programs that affect the measured indicators, but not the underlying causes ("teaching to the test").[13]

5. Risk is not completely transferred to the private sector.

Some claim that SIBs are a riskless financial instrument. This is a misconception. Philanthropic capital has been the major source of financing for SIB projects and has been used as a backstop for private capital. One primary lesson learned from the Rikers Island SIB is that "To attract investment, it is probably necessary to eliminate sharp distinctions between program success and failure – or from the investor's point of view, sharp distinctions between repayment and a total loss … it may be necessary for benevolent funders to step in to "smooth the curve" for more traditional investors."[14] A report by

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[9] *From Potential to Action: Bringing Social Impact Bonds to the US*, McKinsey & Company.

[10] *Brookes admits to unease about social investment*, Civil Society Finance.

[11] *How Social Impact Bonds Put Private Profit Ahead of Public Good*, Mark Rosenman.

[12] *Government Performance Task Force Hearing: Investing in What Works: Exploring Social Impact Bonds*, U.S. Senate Budget Committee.

[13] *Social Impact Bonds: Overview and Considerations,* Center for Law and Social Policy (CLASP).

[14] *Financing Promising Evidence-Based Programs: Early Lessons from the New York City Social Impact Bond.* MDRC.

Godeke Consulting found that many investors are uncomfortable with the prospect of being locked into a SIB contract with a long duration and concluded that future SIBs may need to involve more risk sharing – not risk transfer – from government.[15] A related concern brought up by the Urban Institute is that SIBs require prior governments obligate future government to spending on the SIB. Accordingly, SIB investors may demand that contracts contain "full faith and credit" provisions and/or a waiver of a state's "sovereign immunity" to ensure payment.[16]

6. SIBs will not spur innovation in public services.

Many of the interventions supported by social impact bonds are not innovative. Profit-seeking investors are risk-averse and will seek safer returns. Investors will be drawn to funding a handful of programs that benefit from previous evaluation. Even Goldman Sachs and Bloomberg Philanthropies acknowledged in their joint statement about the Rikers Island SIB that the funded approach "had a strong evidence base of successfully reducing recidivism." Consequently, the SIB privatizes a substantial portion of savings to the investor. Rewards, not risks, are shifted to the private sector.

The narrow focus of a SIB program poses problems to governments and stakeholders engaged in or considering broader policy change. For example, do SIBs take options like reducing the number of questionable misdemeanor arrests or making access to bail easier off the policy table because they are not measureable? The Rikers Island SIB operated under the assumption that participating in the ABLE program would reduce recidivism. However, early analysis revealed that the program was not reaching as high a proportion of the population as hoped, even with incentives to participate. The intermediary described that "[t]he problems seem to have arisen from structural impediments directly related to the dynamics of the jail and its operating conditions, and from external obligations that keep participants from attending community-based MRT sessions."[17] Program elements were modified, but because SIBs require high degrees of statistical control in order to determine causality, they had to assure that any adaptations did not compromise the intervention. The SIB arrangement forces the program to focus on achieving results and short-term performance, which in turn limits innovation. Ultimately, the intervention failed because of poor design.

7. SIBs will reduce transparency and accountability.

The SIB structure obligates the government to make payments if the project is successful. However, the intermediary coordinates the financing and manages the service providers. The public loses control and operations and service delivery is less accountable and transparent. Unintended consequences and externalities, not taken into account at the time the SIB arrangement is created, cannot be addressed. Often the terms of an SIB are negotiated without any public input and the final contract is not publicly available. The loan agreements are dense and complex. The public will find it difficult to hold the parties accountable or even understand the monitoring and oversight mechanisms that ensure contract compliance.

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[15] *Building a Healthy & Sustainable Social Impact Bond Market: The Investor Landscape*, Godeke Consulting.
[16] *Five Steps to Pay for Success: Implementing Pay for Success Projects in the Juvenile and Criminal Justice Systems*, The Urban Institute.
[17] *Financing Promising Evidence-Based Programs: Early Lessons from the New York City Social Impact Bond.* MDRC.