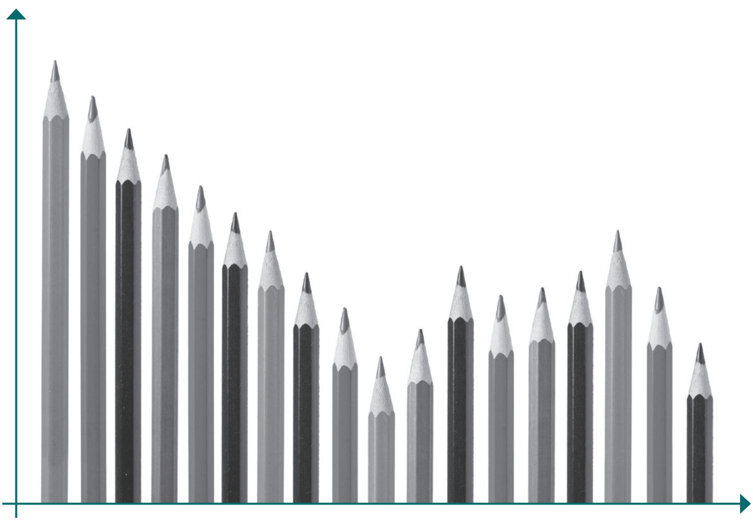
RISKY BUSINESS

Social Impact Bonds and public services



Analysis

Nigel Keohane, Ian Mulheirn
and Ryan Shorthouse

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EXECUTIVE SUMMARY

> *"Our vision is to create nothing less than a new pillar of finance for social ventures. A third pillar to stand alongside traditional giving, and funds from the state"*
>
> Danny Alexander MP, Chief Secretary to the Treasury, SMF Conference, December 2011

The UK faces two major challenges in public services. First, evidence shows that the productivity of public services has flat-lined over the last fifteen years. Second, the Government has reduced expenditure on public services and is set to make further cuts in the years ahead.[1] The challenge to get more for less in public services has never been greater.

Responding to this problem, the Government is looking to boost innovation in public services by enhancing the operational autonomy of frontline professionals and practitioners, and encouraging new thinking. That is fine in theory, since those on the frontline are more likely than central government officials to know 'what works'.

But under conventionally commissioned services, allowing such flexibility separates financial accountability from control over the service provided. The resulting problem is that the financial risks of inferior ideas or inept delivery remain with the taxpayer. To progress the agenda, the state must therefore also devolve the financial risk as close as possible to those in control of interventions, so that they are financially accountable for their decisions and consequently have a clear incentive to succeed. Effective transfer of financial accountability is therefore the holy grail of public service reform. This paper explores whether and how the Government can

1 Royal Society for the encouragement of Arts, Manufactures and Commerce 2020 Public Services Trust, *From social security to social productivity: a vision for 2020 Public Services* (London: RSA, 2010), http://clients.squareeye.net/uploads/2020/documents/PST_final_rep.pdf, 8.

achieve these goals through Payment by Results (PbR) and Social Impact Bonds (SIBs) in particular.

Social Impact Bonds differentiate themselves from other forms of payment by results in the way their financing is structured. Initial investments are expected to be undertaken entirely by private or philanthropic investors and the government only pays the investors if and once the results are achieved. Financial rewards for SIBs are coupled with social outcomes, such as improved health, sustainable employment or reduced re-offending rates.[2] The principal innovation of SIBs is the transfer of financial risk away from the public sector to the private sector, while at the same time allowing investors and providers greater freedoms in the design of services. Taken together, these should improve accountability and innovation in the provision of public services.

Initial interest in SIBs was spurred by the pioneering work of Social Finance.[3] Growing interest in the social investment market has seen the Cabinet Office and others explore how the agenda can be pursued.[4]

However, there has been less analysis comparing the specific benefits of commissioning through a SIB rather than through other forms of payment by results. And given the significant role that the Government envisages for SIBs, an obvious question that arises is why there aren't very many of them in operation. This paper seeks to address these two questions, before presenting some recommendations for how policymakers can seek to expand the role of SIBs in the delivery of public services.

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2 Cabinet Office, *Social Impact Bonds* (London: HMSO, 2013).

3 See, for instance, Social Finance, *Social Impact Bonds: rethinking finance for social outcomes* (London: Social Finance, 2009).

4 Cabinet Office, *Growing the social investment market: a vision and strategy (London: HMSO, 2011); Cabinet Office, Growing the social investment market: progress update* (London: HMSO, 2012).

Chapter 1 explores **the variety of different payment-by-results approaches**, isolates the unique characteristics of social impact bonds and sets out the case for commissioning through a SIB. The main findings are:

- Payment by Results offers a way to maintain competitive pressure on providers between contracting rounds and, by devolving financial accountability, the approach can free-up front line innovation in the delivery of services.
- There are a variety of PbR models. First, there are public-sector financed and delivered projects, such as those being tried in public health. A second model is the Doncaster prison approach, where services are privately delivered but publicly financed with service fees having to be repaid by the contractor in the case of poor performance. The third approach is the privately-provided and privately- financed model, of which the Work Programme is an example. The desirable characteristics of PbR are strongest under the third approach, but so is the associated cost.
- The case for using Social Impact Bonds as a specific form of PbR is compelling. They can facilitate greater pluralism and competition in the provider market; they offer the possibility of involving specialist organisations in delivery; and they can be used as small scale pathfinders to develop new approaches to service delivery.

  However, some of the principal benefits often attributed to SIBs will not necessarily materialise. At scale, SIBs could come to resemble the prime contractor model much more closely than proponents hope, limiting the autonomy of Voluntary and Community Sector (VCS) providers. SIBs lack the economies of scale in design, implementation and measurement that commissioners want. And contrary to common misperception, SIBs will only save taxpayers' money if they improve the productivity of services.

Chapter 2 looks at **what is standing in the way of SIBs** being a bigger part of the public services reform agenda. These barriers include the following:

- The very high degree of uncertainty surrounding new interventions, combined with the measurement problems of small-scale projects, ratchets up the level of reward payments needed to attract investors in large numbers.
- Early adopters face disproportionately large set-up costs. The risk aversion of commissioners as well as investors inevitably means that they will be nervous about meeting these costs. All of these factors make it difficult to develop investable propositions.

Chapter 3 explores how policymakers should look to overcome these barriers and **how to help promote the market for SIBs**. There are broadly four areas where action would be needed to get more SIBs off the ground.

- First, Government should seek to minimise the informational uncertainty that drives a wedge between commissioners and investors. In particular, efforts are needed to: improve outcomes measurement; strengthen the attribution of interventions to outcomes; facilitate more evaluation about what kinds of interventions work; and help to standardise some aspects of SIB development to lower transaction costs.
- Even with reduced uncertainty, SIBs will likely require subsidy from one party to the deal or the other. On a small scale, philanthropic investors may be willing to subsidise SIBs, as is happening in the Peterborough pilot. But if SIBs are to be a larger part of the public service reform landscape, commissioners will have to subsidise them by offering large enough rewards to attract the appropriate level of investment. This may raise questions about value for money.
- Finally, there is much that government can do to help boost readiness among investees, and to make it easier for them to

engage in PbR projects of all types, such as by standardising aspects of their design.

In the search for productivity improvements in public services, SIBs are an exciting development. As the market evolves, there is a wider debate to be had about the potential role for SIBs. Two particular scenarios present themselves.

In the first scenario, SIBs could always operate on the frontier of innovation, breaking new ground but not seeking to become a mainstream commissioning model. Under this approach, SIBs would always be heavily subsidised by government or philanthropists. A consequent danger is that the market signals that underpin the theoretical case for SIBs are so blunted by "soft money" that the model fails to have the desired innovative impact. Alternatively, SIBs could be used as a mainstream commissioning structure. But for this to happen, a great deal of action needs to be taken to close the risk gap between the returns that would-be investors demand, and the price that commissioners are prepared to pay. It is too early to say which of these distinct roles SIBs could ultimately play in the commissioning of public services. The answer will depend on how policymakers respond to the challenges outlined here.

In December 2011, the SMF hosted a conference on social impact bonds attended by Government Ministers, social investors, intermediaries, local authorities, social sector organisations and academics. Given the level of interest in the topic at the event and through 2012, the SMF has drawn together key threads from the discussions together with more recent policy developments to make an assessment of the case for social impact bonds in the UK and an analysis of whether and how they can be scaled up in the future.[5]

5 SMF, "Risk and reward: can social impact bonds breathe new life into public services?", http://www.smf.co.uk/events/all-events/risk-and-reward-can-social-impact-bonds-breathe-new-life-into-pu/?eID=72.

CHAPTER 1: SOCIAL IMPACT BONDS AS PAYMENT BY RESULTS

This chapter assesses the case for social impact bonds. It starts by exploring the need to reform public services and the motivation for commissioning through payment by results. It goes on to assess the different options available to pursue this approach, and the unique advantages of commissioning through a social impact bond.

THE NEED TO REFORM PUBLIC SERVICES

Pressure on the UK's public finances is growing. The challenge of deficit reduction looks set to run well into the next parliament. The SMF has calculated that the Chancellor's March 2012 budget implies that a further £33bn will be cut from departmental budgets by 2018 to get the deficit in the public finances under control.[6] In addition, long-term developments such as an ageing population, the growth in chronic diseases and rising inequality look set to add further pressure on demand for resources.

This comes against a backdrop of stagnant public services productivity over recent years. Between 1997 and 2008, public sector productivity (as measured by expenditure on services compared with outputs) is estimated to have fallen by an average of 0.3% per year.[7] Public services therefore need to raise their productivity if services are to meet citizens' expectations at a price they are willing to pay through their taxes.

In the face of these fiscal and productivity challenges, the Coalition Government is determined to reform public services so that they 'display the same innovative and entrepreneurial drive that characterises the best of the UK's economy and society'.[8]

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6 Ian Mulheirn, Nida Broughton, Ben Lucas, Henry Kippin, *Fiscal fallout: the challenge ahead for public spending and public services* (London: SMF, 2012).

7 Royal Society for the encouragement of Arts, Manufactures and Commerce 2020 Public Services Trust, *From social security to social productivity*, 8.

8 HM Government, *Open public services 2012* (London: HMSO, 2012), 4..

The Government is pursuing market-based solutions to achieve reform, aiming to create more choice for users and competition between providers.[9] Building in part on the reforms of the last Labour Government, through personal budgets and vouchers in some areas, the Government wants service users to shop around, encouraging innovation and driving up value-for-money across a market of providers.

Under the right conditions – such as in social care – devolving responsibility to the individual level has the potential to achieve great value for citizens. But choice has its limitations with some public services simply not amenable to competition within markets.[10] In regulated monopolies and services provided to individuals for the benefit of other citizens – such as offender rehabilitation– other approaches to driving better value for money are needed because users' choices cannot drive value.

The traditional tool for achieving this, over the past three decades, has been competitive tendering, where would-be providers bid to operate the service in question. Yet, in between contracting rounds, competitive pressure is weak, reducing incentives for providers to continually improve their performance. Conversely, raising the frequency of re-contracting rounds to stimulate competition tends to undermine incentives for providers to invest in their provision, since short contracts do not allow them to recoup their investment within the contract period. Frequent re-contracting also raises large transaction costs. Faced with this dilemma, government has to find alternative tools to drive productivity improvement within the lifetime of the contract. To this end, the Coalition Government and its Labour predecessor have begun to make providers compete to deliver services through outcome-based commissioning or Payment by Results.

9 Ibid.

10 For a discussion of this, see Ian Mulheirn and Barney Gough, *More for less: rethinking public service delivery* (London: SMF, 2011).

PAYMENT-BY-RESULTS

Under Payment by Results (PbR), the provider of public services is only paid in full once it has achieved certain outcomes. Providers receive only part (or in some cases none) of their payment in advance (the core payment) and the remainder is contingent on achieving specified outcomes (the reward payment). The Government believes that PbR could 'build yet more accountability into the system – creating a direct financial incentive to focus on what works, but also encouraging providers to find better ways of delivering services.'[11]

Theoretically, PbR can help tackle the twin problems of falling productivity and long-term fiscal pressures, as well as addressing the changing needs of service users by allowing for more tailored services. In practice, however, it is difficult to assess its success in the areas in which the approach has been tried: the evidence, from the UK and abroad, is mixed (see Box 1.1). Nevertheless, it seems reasonable to conclude that, if designed well, such approaches can be effective.

Box 1.1. The effectiveness of PbR

A small number of research evaluations, in the UK or abroad, show the effectiveness of PbR in increasing the efficiency and performance of public services. A study of five organisations commissioning children's services in the UK – including local authorities – found that an outcomes-based approach to accountability led to greater partnership working. In Australia, private sector organisations bid for Job Network services and are paid depending on employment outcomes for those jobseekers engaged: an evaluation a year after it was introduced in 1998 found that employment outcomes were just as good as the state-run scheme but were achieved at a lower cost and with higher user satisfaction.[12] Contrarily, the National Audit Office found that PbR failed to deliver better outcomes than the JobCentre Plus alternative when applied to employment services for long-term sickness benefit claimants in the UK.[13]

11 HM Government, *Open public services*, 33.

12 Mulheirn and Gough, *More for less*, 52-54.

13 National Audit Office, Department for Work and Pensions: Support to incapacity benefits claimants through pathways to work (London: National Audit Office, 2010), 6-12.

Both central and local government are increasingly seeking to commission a range of public services through PbR. Examples include Sure Start Children's Centres, rehabilitation support for offenders, and welfare-to-work provision. There is an appetite in government for extending the concept to more policy areas, such as children in care, homelessness and the rehabilitation of short-term offenders.

So why is PbR seen as a promising approach for policymakers? The attractions stem from three possible benefits. PbR can:

- **Stimulate innovation** by freeing providers to design their own interventions. Government can devolve operational autonomy because providers assume the financial risk of their decisions. This commissioning approach incentivises providers to focus on identifying what works, rather than simply delivering processes, targets or volumes of service that central government believes are associated with good outcomes.
- **Leverage up-front private investment** where the state may be unable or unwilling to finance new interventions directly from the public purse from the outset. This is particularly helpful where a shift to preventative interventions is desirable but unproven. Where new services can improve lives and save the state money, up-front private investment may be the only way to finance the intervention, particularly when public money is tight.
- **Increase the competitive pressures** on providers to innovate and improve productivity throughout the length of a contract, rather than simply at the point of re-contracting, by paying for outcomes rather than processes.

But in order to realise these benefits, two other conditions are necessary.

- There must be **organisations that are ready to invest and assume the financial risk** on the financial terms offered.
- **A plural and diverse market of potential delivery organisations** capable of winning and delivering contracts is essential if the provider market place is to be sufficiently competitive to stimulate innovation and hence productivity improvements.

How PbR models are designed is critical in ensuring that these conditions are met. So what are the different approaches that could be deployed?

DIFFERENT MODELS OF PAYMENT BY RESULTS

There is a choice for commissioners about the right mix of core and reward payments they offer. Often this will be determined by the nature of the service, its capital intensity and the extent of desired risk transfer. Here we focus on how the reward payments are designed. Commissioners can adopt PbR in three principal forms, determined by the source of finance for the reward-funded part of the programme and whether the provider is a public or an external organisation. It is important to note that in all cases the state ultimately funds the reward payments.

1. Public finance; state delivered
2. Public finance; non-state delivered
3. Private finance; non-state delivered

We explore each of these models, and their advantages and disadvantages, in turn.

Public finance; state delivered

Under this approach, PbR schemes are wholly state-operated: public money is used to finance interventions and public bodies provide the services. In a sense, then, this is a targets regime backed by financial sanctions. Examples include:

- The Department of Health's plan to give local authorities incentive payments where they succeed in improving various public health indicators.[14]
- Payments made to GPs when they carry out specific activities (although these usually relate to desirable outputs from professionals rather than the final outcome, such as reduced morbidity or better health).

A state-operated PbR scheme may offer some of the enhanced incentives necessary to stimulate innovation and improve value for money. However, since the financial risk of failure is retained in the public sector, the incentives are likely to be limited. The risk of failure is unlikely to act as a major spur to improvement, since the public provider cannot be allowed to fail. Of course, where the management are made to bear the consequences of failure, improvement could be encouraged, but this can be achieved without PbR.

Second, it is questionable how credible or fair it would be to threaten to cut public funding to services that are performing poorly. For example, if less public money is spent in areas with poor public health outcomes, those outcomes are only likely to deteriorate further.

Finally, where there is a monopoly of provision, such as when paying local authorities by results, competition is absent. This is not inevitable within public provision, but where monopoly provision is the rule, it is unclear how much more effective financial incentives are likely to be than targets.

14 Department for Health, *Health lives, healthy people: improving outcomes and supporting transparency* (London: HMSO, 2012).

Advantages	Limitations
Sharpens focus of public sector provision on relevant outcomes and encourages innovation	Is it credible for government to cut funding to local authorities with deteriorating outcomes? Can commissioners act on what the PbR outcomes data tells them?
	Limited provider competition in monopoly public services
	Limited incentives for efficiencies beyond those available in a targets regime
	Public sector retains financial risk of failure, reducing incentive for government to allow the frontline professionals the freedom to innovate

Public finance; non-state delivered

Under Model 2, the service is outsourced to a private, or voluntary or community sector (VCS) organisation or social enterprise (a business that trades for a social or environmental purpose). Payments are made for delivery of the service with some element of the payment placed 'at risk', such that the provider must repay some money if certain outcomes are not achieved. In effect, therefore, the state loans the provider money to undertake the necessary interventions, demanding repayment in the case of failure. In these instances, the provider may not have to inject their own capital if they are able to deliver the service within the income provided by the contract. As such, the service will remain publicly financed.

Box 1.2 Example: Serco and Doncaster Prison

An example of this kind of contract is Serco's HMP Doncaster contract where 10% of the contract revenue is dependent upon the achievement of a five percentage point reduction in reoffending. Failure to achieve the target will result in Serco's revenue being cut in the later years of the contract. In addition, if Serco achieves a reduction of greater than five percentage points in reoffending, it will receive an additional outcome payment.[14]

Compared to Model 1, this approach has the advantage of widening the pool of possible providers, leading to greater competition and perhaps greater efficiencies. In addition, the use of public money to finance interventions reduces the cost of interventions relative to those financed by private investment, since government can borrow more cheaply.

However, the flip-side of that fact is that the state continues to bear much of the financial risk of failure since it may not be able to recover money from providers that fail. In essence then, the state is offering a heavily subsidised loan. This model represents only a limited transfer of risk to the provider, and incentives to innovate are commensurate.

Advantages	Limitations
Greater pool of possible providers, leading to more competition and innovation	Reliant on up-front public finance to fund interventions
Some risk transfer to providers	Public sector retains most of the financial risk of failure

Private finance; non-state delivered

It may be desirable to transfer more financial risk to providers by requiring them to finance their own interventions and only paying

15 Daniel Murray, Jonathan Jones, Simon Pearce and Evelyn Hichens, *Findings and lessons learned from the early implementation of the HMP Doncaster payment by results pilot* (London: Ministry of Justice, 2012).

them for achieving successful outcomes. This greater degree of risk transfer offers the sharpest incentives to find better ways to deliver services, and frees the commissioner from any need to stipulate processes from the centre. Incentives can be sharpened further by shifting more of the payment from the core to reward parts of the contract.

However, the approach is no panacea. First, the risks around such projects can be substantial, raising the possibility that subsequent success payments will not cover the costs of the intervention. This risk can be large where outcome prospects are unknown or unclear to investors. Second, in attempting to transfer such a high degree of risk, government is invariably made to pay for the pleasure by making the likely pay-off big enough for investors to want to get involved, and for the returns to cover the higher cost of financing the scheme from private sources. Third, in conditions where large amounts of finance are required, smaller and more specialist providers such as Voluntary and Community Sector (VCS) organisations – sometimes the ones with the innovative ideas to improve value for money - are unable to take on the risk.[16] This limits the pool of potential providers and hence the competitiveness of the market. Similar dynamics have been observed in the PFI market.[17]

Therefore, in major PbR programmes the principal contractors are likely to be large private sector providers. These organisations draw on their own balance sheets or borrow money to inject the upfront finance into projects, take responsibility for service delivery, and reap any rewards at the end of the contract.

16 Audit Commission, *Local payment by results* (London: Audit Commission, 2012), http://archive.audit-commission.gov.uk/auditcommission/sitecollectiondocuments/Downloads/20120405localPbR.pdf.

17 House of Commons Treasury Select Committee, *Private Finance Initiative* (London: HMSO, 2011).

Box 1.3 Example of Model 3: Prime Contractor PbR in the Work Programme

Under the Work Programme, 18 prime contractors were selected by government to deliver welfare-to-work interventions with adults who have been unemployed for more than 12 months, and young people who have been unemployed for more than nine months. They are paid an 'attachment fee' by DWP to assist with initial service delivery costs.[17] However, by 2014 the attachment fee will drop away and providers will be paid entirely on outcomes. Contractors are given an outcome payment once one of their jobseekers has been in sustained employment for 13 or 26 months (dependent upon the type of claimant). Payments vary according to jobseeker characteristics in an effort to reduce the likelihood that providers will 'park' harder to help clients. [18]

In examples such as the Work Programme, these dynamics have meant that it is only viable for government to contract with large organisations in a prime contractor model. Indeed, under the Work Programme, there was an explicit limit on the size of organisations that were permitted to bid for contracts: a minimum turnover of £20 million per year. [20] Dealing with a few large organisations has the advantage of reducing the costs associated with contracting. But to the extent that it does so, it excludes the smaller and potentially more innovative providers. Some large providers seek to resolve this by sub-contracting many elements of delivery to smaller delivery partners. This injects some innovation but means that the transaction costs of the PbR approach can be substantial. So there is an inevitable trade-off here between the virtues of economies of scale and those of service innovation.

18 Ian Mulheirn, *Will the Work Programme work?* (London: SMF, 2011).

19 Ibid.

20 Department for Work and Pensions, "The Work Programme invitation to tender: specification and supporting information", http://www.dwp.gov.uk/docs/work-prog-itt.pdf.

Finally, it is important to recognise that not all risk is transferred away from government, since it is rarely possible for government to allow poor performing providers to fail without incurring political costs.

Advantages	Limitations
Possibly a greater pool of possible providers, leading to more competition	Transaction costs can be high in prime contractor models
Potential for major efficiencies due to very sharp financial incentives	State must ultimately compensate providers for the scale of the risk they assume. Policy makers may transfer risk, but they will pay for the risks that providers cannot control.
Outsourcing of financial risk	Where there is substantial risk, only those firms with big balance sheets can engage, shutting out many private and community sector organisations and reducing innovation and competition.

SOCIAL IMPACT BONDS AS A FORM OF PBR

The prime contractor model is not the only form of privately financed and externally delivered PbR that is available. A variation on this form of PbR is a Social Impact Bond (SIB). This term reflects the pioneering work of Social Finance in setting up the first such arrangement to help offenders at Peterborough Prison.

In general terms, under a SIB, an investor takes some financial risk for achieving outcomes and distributes the upfront investment for project-specific purposes (although often this is done through an intermediary). The provider of the capital is separate from the delivery organisation. Investors receive a return on their investment via a reward payment from the commissioner only if certain outcomes have been met. Unsurprisingly, policymakers are currently keen to identify opportunities for SIBs where investors can be repaid out of savings to the taxpayer.[21]

Often, the relationship between the investor and the delivery organisation is managed by a financial intermediary, though this need not theoretically be the case.[22] These intermediaries attract money from social investors, provide capital to front-line ventures (typically social sector organisations), offer expertise to social ventures such as skills and contacts, offer suitable financial products and measure the impact and effectiveness of charities. Intermediaries also often hold the money put in by the investor and distribute this to the provider on completion of certain agreed tasks, although the money may be held in a separate special purpose vehicle. Examples of intermediaries include Social Finance Limited and Big Issue Invest.

SIBs seek to resolve some of the limitations described in the sections above. In particular, they hold out the possibility of the following benefits:

- **Pluralism.** By expanding the range of sources of investment and making finance directly available to a wider range of organisations, SIBs are intended to improve the diversity of the investor and provider markets, encouraging competition and innovation. They can facilitate the expansion of social sector activities by overcoming the cash flow problems, uncertain demand and short contracts that usually make such expansion difficult.
- **Specialism.** By allowing smaller and more specialist organisations to get involved in delivery, SIBs may bring greater expertise compared to markets in which only a handful of large firms can operate.

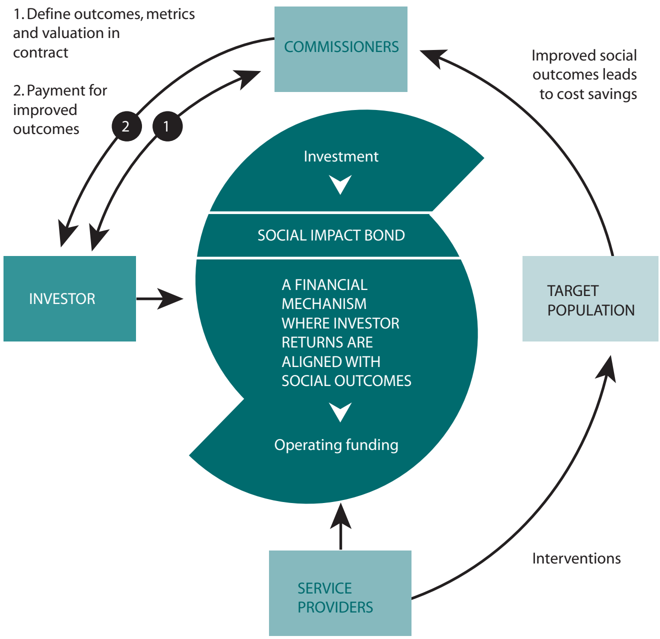
21 Geoff Mulgan, Neil Reeder, Mhairi Aylott and Luke Bo'sher, *Social Impact investment: the challenge and opportunity of Social Impact Bonds* (London: The Young Foundation, 2010).

22 The 10 largest social finance intermediaries channel approximately 96% of all social investment in the UK; Cabinet Office, *Growing the social investment market*.

- **Information.** By piloting new interventions on a small scale, SIBs can help to demonstrate what works and the kind of change in outcomes that it is possible to achieve. In reducing some of the uncertainty, such projects may help to lower the future cost of capital of proven interventions. In addition, SIBs allow providers to learn on the job, and policy makers to evaluate the effectiveness of interventions whilst delivery is on-going. This speeds up the typical process from pilot to evaluation to implementation.[23]

In other words, SIBs may offer numerous advantages: delivery diversity and sustainability, frontline expertise, and sharp financial incentives.

Figure 1.1. Example of flow of money in a Social Impact Bond (Social Finance)



23 Joseph B. Liebman, *Social Impact Bonds: A promising new financing model to accelerate social innovation and improve government performance* (Washington DC: Center for American Progress, 2011), http://www.americanprogress.org/wp-content/uploads/issues/2011/02/pdf/social_impact_bonds.pdf, 10.

However, few SIBs have been developed to date (see Box 1.5 for SIBs under way or in development). Launched in September 2010, the first Social Impact Bond in the world – called One*SIB – is for rehabilitation interventions at Peterborough Prison. Philanthropic investors, such as Barrow Cadbury Trust and Esmee Fairbairn Foundation, have invested in a bond to pay for interventions to rehabilitate offenders and reduce recidivism. Organisations such as St Giles Trust, Ormiston Trust and YMCA are involved in the delivery of services. Investors will only receive reward payments – and hence a return on their investment - if the reoffending rates for short-term offenders, measured by the number of court appearances in the subsequent year, reduce by a specified amount. If, at the end of the project, there is a 7.5% reduction overall, investors will receive a return. The return they receive rises as performance improves, but is capped at 13% per year. If performance falls short of the 7.5% minimum level, the investors will receive no payment from the Ministry of Justice, and will have forfeited not just a return on their investment but the principal as well.[24] On these exacting terms, it is unsurprising that the Peterborough SIB is reliant on philanthropic money.

The concept of SIBs is now being exported. In the US, they are called "pay for success bonds".[25] In Maryland, for example, the Family Recovery Programme Compact aims to reduce the length of stay for children in foster care, reaping typical savings of $30K per child, which can be used to pay a return to the original investor. Similarly, the 'multi-systemic therapy compact' in Maryland enables the running of positive alternatives to juvenile incarceration, saving up to $91K per young person.[26] In New York, a rehabilitation

24 Sion Cave, Tom Williams, Darrick Jolliffe, Carol Hedderman, "Peterborough Social Impact Bond: an independent assessment", Ministry of Justice Research Series 8/12, (2012), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/162352/peterborough-social-impact-bond-assessment.pdf.pdf, ii.

25 The White House Office of Management and Budget, "Paying for success", http://www.whitehouse.gov/omb/factsheet/paying-for-success.

26 National Conference of State Legislatures, "Maryland opportunity compact review", http://www.ncsl.org/documents/sfn/MD_impactbonds.pdf.

programme is being funded by Goldman Sachs and run as a social impact bond.[27]

Box 1.4 Where are SIBs being applied or under development

There are currently 13 SIBs in operation in the UK; 10 of these are delivered through the Department for Work and Pension's Innovation Fund, with the aim of reducing youth unemployment. The list below sets out areas where SIBs are currently, or in the process of, being applied, and examples.

- **Offender rehabilitation**. Peterborough Pilot.
- **Reducing youth unemployment**. Tridos New Horizons in Merseyside; T&T Innovation Ltd in North West England; Energise Innovation in the Thames Valley area; 3sc in Cardiff and Newport.
- **Children on the edge of care**. Essex County Council; Manchester Troubled Families Project
- **Reducing acute care among elderly population**. Age UK and Improving Care are developing a SIB on ageing and care in Cornwall
- **Reducing homelessness**. The Greater London Authority and the Department for Communities and Local Government is working with St Mungo's to support 400 rough sleepers in London.[27]

A PANACEA?

As outlined above, there are compelling theoretical arguments to develop the concept of privately-financed, project based schemes. But there are reasons to be cautious about some of the oft-cited benefits of SIBs, which can be hard to realise.

27 David W. Chen, "Goldman to Invest in City Jail Program, Profiting if Recidivism Falls Sharply", *The New York Times*, August 2, 2012.

28 HM Government, "Social Investment: transforming lives", https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207741/g8-infographic.pdf; Cabinet Office, "Centre for Social Impact Bonds: case studies", http://data.gov.uk/sib_knowledge_box/case-studies.

First, it is sometimes claimed that SIBs could give not-for-profit providers a better deal and more autonomy than under conventional PbR models.

It is questionable how far SIBs, operated on a large scale, would create a straightforwardly benign commissioning model for VCS delivery organisations. On the positive side, VCS organisations would be able to access finance and not be left vulnerable to being passed the difficult clients, as can happen in a prime contractor model, and evidence suggests has occurred in some cases under the Work Programme.[29] However, if investors are to provide large amounts of finance, they are unlikely to be content to allow delivery organisations complete operational independence. The standard SIB model involves an investor-owned special purpose vehicle containing a Performance Director who monitors the activities and performance of the providers and is accountable to the Board of Investors. As a result, the model could acquire characteristics of the prime contractor model with investors setting delivery requirements of providers, for good or ill.

Second, while finance has been secured on extremely attractive terms available for the small scale schemes progressed thus far, any large scale service provision through a SIB model would be unlikely to benefit from the same cheap capital. The greater the scale, the closer must be the risk-adjusted rates of return to the market rate if investment is to be found in sufficient quantities.

Third, SIBs are an expensive method of expanding social sector interventions. They are programme specific, thus requiring in-depth analysis of the impact of interventions in a specific environment. Independent evaluation of performance under the SIB is expensive. Such costs absorb a significant proportion of the

29 James Rees, Rebecca Taylor and Chris Damm, "Does sector matter? Understanding the experiences of providers in the Work Programme", Working Paper 92, (Birmingham: Third Sector Research Centre, 2013), http://www.tsrc.ac.uk/LinkClick.aspx?fileticket=oJrkSIkyQyg=.

returns available to investors or value to commissioners. Related to this is the problem that their small scale and bespoke nature means that the transaction costs of setting up a SIB can be prohibitively large.

Fourth, SIBs do not necessarily reduce government expenditure. Although government does not finance a SIB, it ultimately still has to pay for the service provided. SIBs are therefore simply an alternative way of commissioning a service that may be helpful in improving productivity in public services. If successful in this regard, SIBs would allow expenditure to be cut without a reduction in service quality.

Finally, previous experiences with the Private Finance Initiative in infrastructure investment should act as a cautionary lesson about the need for great care in adopting new financing methods such as SIBs. Under early PFI projects, government was widely considered to have borne too much risk.

Despite the limitations above, Social Impact Bonds are a potentially powerful tool for achieving important goals as the concept of PbR comes to be applied more widely. So, why is there not wider use of SIBs? Why are they not driving innovation across public services generally?

In the next chapters, the report examines the barriers to greater use of SIBs, and considers ways to overcome them.

CHAPTER 2: WHAT ARE THE BARRIERS TO SIBS?

Chapter One demonstrated that social impact bonds could be an important way to help boost innovation and productivity in public services at a time when state funding of public services is set to continue to shrink. However, the market for SIBs remains undeveloped. This chapter explores the reasons why. Chapter Three then goes on to assess how to overcome these barriers and to boost the SIBs market.

Advocates for SIBs need a clearer idea of what stands in the way of their being more widely deployed. Social Finance and others have categorised essential criteria that need to be in place for a SIB to succeed.[30] These limit the range of policy problems that can be tackled through SIBs. However, beyond these, there are four particular problems that affect investors, commissioners and deliverers that constrain the growth of the SIBs market:

1. The extremely high degree of uncertainty that investors face significantly ratchets up the reward payments necessary to attract them in large numbers.
2. Early adopters face disproportionately high costs of commissioning a SIB.
3. Commissioners are likely to err on the side of caution in the terms they offer investors.
4. There is a lack of investment readiness among social sector and commissioning organisations.

1. EXTREMELY HIGH LEVELS OF UNCERTAINTY THAT PUSH UP THE COST OF CAPITAL

The outcomes of radical new interventions in social policy are almost always very uncertain. So a SIB investor is typically risking

30 These are presented in Mulgan, Reeder, Aylott and Bo'sher, *Social Impact Investment*, 21-22.

not just low returns but sometimes their principal investment. As discussed, an example of this is the Peterborough SIB, where the financial terms offered by the Ministry of Justice are so stringent that no ordinary investor would be willing to take such a project on (see Box 1.3).

Many public services could benefit from the innovation impulse that preparation for a SIB can trigger. But, for SIBs to attract more capital, investors will want compensation for the large possible variation in outcomes – a premium for assuming outcome risk. In other words, the 'risk-adjusted' return (RAR) needs to be higher than that on safe investments if investors are to be attracted on a large scale.

The risk-adjusted return

Different projects have different levels of risk, which is reflected in the return expected by investors. Some projects will have a high rate of return to compensate investors for high risk. This means that to make fair comparisons of returns between projects, it is important to use a risk-adjusted return, which reflects the risk that an investor would be taking on.

What might appear, in absolute terms, to be a strong maximum rate of return on offer in a SIB, may actually represent a very low risk-adjusted return. The One* SIB funding Peterborough Prison rehabilitation interventions is a case in point. The prospect of losing the principal lowers the risk adjusted return hugely. Indeed, in the Peterborough case, the RAR is likely to be heavily negative. For this reason, McKinsey has concluded that 'because the risk of principal loss [in a SIB] is unlikely to ever be offset by the potential financial upside, only investors who care about the social bottom line to some extent are likely to care about SIBs.'[31] McKinsey's conclusion

31 McKinsey and Company, *From potential to action: bringing Social Impact Bonds to the US* (2012), http://mckinseyonsociety.com/social-impact-bonds/#sthash.z9Er0uYa.dpuf, 54.

would appear to hold true for the Peterborough SIB. However, it is not clear that a SIB should be a bad deal for an investor. The lesson is simply that given the likely risks, reward payments have to be significant if mainstream investors are to be attracted.[32]

Government's unwillingness to offer such returns explains why Peterborough-style SIBs have had to rely on philanthropic investment, for which the pool of capital is limited. Although in 2010 there was £3.6 billion in philanthropic grant funding in the UK, SIBs will have to compete for this money against many other worthwhile causes. Meanwhile, the social investment market remains small with only £192m of lending in 2010-11 compared to £55 billion of small business lending.[33] In particular, few social investors display the appetite for these equity-like investments, with four-fifths of social investment in secured lending and only 5% (about £8m) in equity or quasi-equity investments.[34]

But what are these risks that drive a wedge between would-be investors and commissioners? They come in three broad forms.

- First, **statistical uncertainty** is a major problem. Commissioners are concerned that the measured improvements in re-offending they will pay for are not simply the result of statistical fluke, but the genuine result of better service provision.

  But there will always be a margin of error in such measurements. This margin of error gets smaller as the number of outcomes being observed is increased. For example, Ministry of Justice analysis suggests that with a cohort of around 1,000

32 Mildred Warner, "Profiting from public value? The case of Social Impact Bonds", (paper presented at a conference at the University of Minnesota, September 20, 2012), http://www.leadership.umn.edu/documents/Warner8.15.12.pdf. See also McKinsey, *From potential to action and Liebman, Social Impact Bonds*.

33 HM Government, *Growing the social investment market; Cynthia Shanmugalingam, Jack Graham, Simon Tucker and Geoff Mulgan, Growing social ventures: the role of intermediaries and investors: who they are, what they do, and what they could become* (London: Nesta, 2011).

34 Adrian Brown and Will Norman, *Lighting the touchpaper: growing the market for social investment in England* (London: Boston Consulting Group, 2011), 12.

offenders commissioners would need to see a reduction in re-offending of around ten percentage points to be 90% certain that the reduction was not a statistical fluke. Even for a cohort of 7,000, the outcome improvement would need to be around six percentage points. If commissioners are to hold investors to such a high bar, they are in fact loading a huge amount of extra risk onto them.

- Second, **attribution risk** is a common stumbling block for all forms of PbR. How can providers (and commissioners) be sure that the effect of their interventions is rewarded appropriately? To ensure that investors are paid fairly for the success of their intervention, robust evidence is needed about the contribution that an intervention made towards the social outcomes desired. Commissioners will have to establish a baseline from which to evaluate the performance of the SIB interventions. These can be based on:[35]

  - Performance compared to a control group (usually the most robust form of evaluating performance).
  - Performance against historical trends.
  - Comparative performance against other contemporaneous outcomes.

  Multiple interventions from different services may be responsible for future savings. This is especially the case over longer periods of time when looking at the outcomes from care services, for example. This makes it difficult to isolate the contribution of specific interventions and actors. What is required is a much greater level of data and outcome monitoring than government currently undertakes. The existing information infrastructure is often too poor to measure outcomes accurately.

35 Big Society Capital and Bridges Ventures, *Lessons from Social Investor involvement in payment-by-result programmes* (London: Big Society Capital, 2012).

A second type of attribution risk concerns the fact that providers may not have full control of aspects of the environment which may serve to increase or decrease the effectiveness of the intervention. These factors might include the performance of the general economy (in the case of the Work Programme) or the performance of the Work Programme (in the case of re-offending).[36] Success has many fathers but failure is an orphan. For SIBs to work we must be able to identify the biological father.

- The third risk that SIB investors face is **innovation risk:** that new interventions are inherently uncertain. With little past effort to supervise sub-12 month prisoners after release, investors seeking to provide these services are taking a huge leap into the unknown.

These three kinds of risk put a huge gulf between investors and commissioners, pushing up the cost of capital and requiring generous reward payments that may be too much for government to justify. This 'risk gap' must be bridged if viable SIBs are to come to fruition.

2. EARLY ADOPTERS' COSTS

Early adopters face disproportionately high costs of commissioning a SIB. These originate in two principal areas, both stemming from the immaturity of the concept, and the markets that underpin it.

First, as set out in Chapter 1, an intrinsic advantage of using a SIB is that it can offer a method to pilot interventions on a small scale. By so doing, it can help reduce the uncertainty associated with particular interventions, thus reducing the cost of capital for

36 For instance, the economic environment may change, thus making outcomes easier or harder to achieve (for instance, the downturn has made the payment terms of the Work Programme less viable as it becomes harder to find employment for clients); see Ian Mulheirn, *Will the Work Programme work?*

future projects. Therefore, by this definition, early adopters of SIBs will be subsidising future adopters. As the outcomes and costs of specific interventions are tested and more widely known, this risk will reduce. Consequently, commissioners who follow in the slip stream will face lower costs of capital.

Second, since the social investment market is small and there is no simple template that can be applied, SIB designs are bespoke in nature, which pushes up the associated costs. This is demonstrated by the much longer completion times of social investment transactions relative to comparable transactions for small and medium enterprises. It took 18 months, for example, to develop the SIBs in Peterborough and Essex.

Both of these factors generate a first mover disadvantage which makes progress difficult.

3. COMMISSIONER RISK AVERSION

As described above, the fog of uncertainty that surrounds the outcomes from a SIB pushes up the reward payments that investors will expect. However, public sector commissioners are likely to be unusually conservative, thus widening the gap further between the expectations of the two parties. This is driven primarily by the understandable risk aversion of public sector commissioners: the fear that the state will end up making huge pay-outs that could appear excessive under public scrutiny.

The experience in the Work Programme and the Ministry of Justice suggests that commissioners tend to err on the side of caution under PbR models. In the Work Programme (which used a Prime Contractor commissioning model), commissioners appear to have demanded hugely over-optimistic performance from providers, with significant implications for the sustainability of the flagship welfare-to-work scheme.[37] The DWP's *minimum* performance requirement of providers in the first year of the programme was 5.5%[38], while providers only achieved 2.3% among the main group of long-term jobseekers.

The high levels of uncertainty, set out in Section 1, aggravate this risk aversion. For instance, in designing the Peterborough SIB, the Ministry of Justice estimated that, with a cohort of 3,000 offenders, a 7.5-percentage point reduction in reconviction rates would be necessary to 'produce a statistically significant difference from the control group'. Rather than sharing this statistical risk, the commissioner has pushed it all onto the investors.[39] This unwillingness to tolerate any significant likelihood of paying for a service that failed is arguably an inefficient risk transfer. This is discussed further in the next chapter.

This risk aversion may also be driven by scepticism among commissioners that they are going to be able to unlock all the cashable savings that have been identified. For instance, benefits that theoretically derive from releasing hospital beds and closing wards are often difficult to deliver in actuality.

4. LACK OF INVESTEE AND COMMISSIONER READINESS

To persuade investors to inject their capital, VCS organisations have to be able to demonstrate that they can take on additional funds and scale up their activities. They also have to possess requisite business planning competences to reassure investors that money will be spent judiciously. However, research has shown that few

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37 Ibid.

38 Six month job outcomes divided by total referrals over the first year of the programme.

39 Emma Disley, Jennifer Rubin, Emily Scraggs, Nina Burrowes and Deirdre Culley, *Lessons learned from the planning and early implementation of the Social Impact Bond at HMP Peterborough* (London: Rand Europe, 2011), http://www.rand.org/content/dam/rand/pubs/technical_reports/2011/RAND_TR1166.pdf, 33-34. The figure was 10% for each cohort of 1,000. Ian Mulheirn, Barney Gough and Verena Menne, Prison break: tackling recidivism, reducing costs (London: SMF, 2010).

social sector organisations are in a position to seek finance. Research by the Boston Consulting Group concluded that 'many, if not most, social ventures are currently unsuitable for social investment' and that many social enterprises have a weak understanding of the implications of taking on external finance.[40] Meanwhile, a Big Lottery Fund survey found that the lack of investment readiness was a 'major cause of drag to the acceleration of social investment'. Investors and intermediaries highlighted particularly low levels of preparedness in relation to suitable financial skills; financial acumen; understanding of social investment; and poor coordination. Many investees believed that charities should not use loans to finance their work.[41]

More generally, many commissioners lack the skills or confidence to commission a SIB. Within the commissioning organisation, designing and deploying a SIB requires strong leadership, a clear understanding of the model's applicability to a project at hand, and effective negotiating skills. To understand their applicability, commissioners will also need to possess, or be able to develop, the necessary underlying data to make the case internally for exploring a SIB. The fragmentation of public spending across different departments and authorities makes this process additionally hard. This fragmented funding is one factor behind the Government establishing its Social Outcomes Finance Fund, which will act as an additional central funding stream and encourage different departments to contribute to SIB projects where the savings from successful outcomes are diffuse.

CONCLUSIONS

Despite the potential benefits of commissioning through a SIB , there are major barriers that impede their widespread use in public

40 Brown and Norman, *Lighting the touchpaper*, 19.

41 Dan Gregory, Katie Hill, Iona Joy and Sarah Keen, *Investment readiness in the UK* (London: Big Lottery Fund and Clearly So, 2012).

services. The huge uncertainty that surrounds such schemes pushes up the cost of capital. This dynamic is aggravated by the risk aversion of public sector commissioners, who err on the side of caution and seek to put the project risks onto the investor. Early adopters of SIBs also face disproportionately high costs – trialling and demonstrating the worth of unproven interventions, whilst operating in an immature market where set-up costs are high. Finally, evidence suggests that many in the social sector are unready to seek external finance, lacking core business planning skills. Chapter 3 seeks to assess whether and how these barriers can be overcome.

CHAPTER 3: HOW CAN GOVERNMENT STIMULATE THE MARKET?

> *"How can we encourage social investment on a big enough scale to achieve real life change? And I don't just mean how can we get businesses to do this as an afterthought, or as part of their corporate social responsibility agenda – important though that is. I mean how can we ensure that social investment becomes – as Sir Ronald Cohen has predicted it will – 'the new venture capital'?*
>
> Iain Duncan Smith MP, Secretary of State for Work and Pensions, SMF Conference

Chapter 1 demonstrated that there may be benefits to commissioning public services through SIBs. They can ensure a more plural market of provision thus boosting competition, ensure that specialist providers are able to compete for contracts and give a clear financial incentive to those on the frontline to innovate effectively. However, Chapter 2 showed that there are significant barriers for investors, commissioners and deliverers that need to be mitigated if the SIB approach is to become a more mainstream delivery model. This chapter sets out a series of steps that could be pursued to boost SIBs and facilitate growth of this nascent model and seeks to set out the most effective methods for the government to subsidise the costs for early adopters.

1. MINIMISING UNCERTAINTY

Given the uncertainty around SIBs a primary goal of policy makers must be to reduce the three forms of risk that make it hard for commissioners and investors to strike a mutually acceptable deal.

Statistical risk to the commissioner can be mitigated through scale: either working with large samples on an individual project or by running multiple schemes in parallel. Both potentially have limitations.

First, statistical risk can be minimised by increasing the scale of PbR schemes, as in the case of the Work Programme. To ensure that the investor is rewarded fairly, reflecting the impact of its interventions, commissioners need to reduce and eliminate the dangers of random error leading to payment for failure. One solution is therefore to make the group at which the policy intervention is directed large enough to reduce the statistical uncertainty around measured outcomes. This is a central justification for the Ministry of Justice's plans to commission payment by results in offender rehabilitation in 21 large areas across the country.[42]

The Government could do this by commissioning at scale under a prime contractor model. But, doing so would favour large delivery organisations and exclude VCS organisations, except as sub-contractors. In such circumstances, small VCS organisations may be vulnerable to the types of risk that they have been exposed to under the Work Programme.

Contract scale is not the only way for commissioners to reduce statistical uncertainty. The risk of paying for failure may be large for any one small scale SIB unless a large margin for error is built in. But across many such projects, the same benefits of scale can be achieved for the commissioner as when a prime provider model is deployed. While Peterborough might require a 7.5 percentage point outcome improvement to be certain of underlying success, 100 such projects would not all have to demonstrate such an improvement for commissioners to be sure they were getting value for money. This is because the number of clients being observed would be 100 times larger and therefore the commissioner could be confident that a reduction in reoffending was not simply a statistical fluke. Such an approach would therefore allow the Government to offer more attractive terms to investors.

Ultimately, whether government can offer better terms for would-be SIB investors depends on the scale of role that they want

42 Ministry of Justice, *Transforming rehabilitation: a revolution in the way we manage offenders* (London: HMSO, 2013).

SIBs to play in the delivery of public services. If they continue to be on the periphery, at the very frontier of public services and tailored to very specific local challenges, then government may be unable to reduce statistical risk by commissioning multiple SIBs. To do that, SIBs would have to be a more mainstream approach.

In tackling the **attribution risk** problem, there is much that government can do. If they are to commit to a SIB, both investors and commissioners must be confident of what would have occurred in the absence of the contractor's interventions.[43] Otherwise, investors will find a SIB too risky an investment proposition or demand higher returns on the capital; or commissioners will confront a real danger of over-paying for the outcomes, and thus be reluctant to engage.

Government can act in two principal ways to reduce attribution risk. First, commissioners can structure the reward scheme in such a way as to take into account environmental factors that may affect the outcomes. This may be through structuring the competition so as to reduce the impact of one major factor. For instance, the Work Programme has two or three providers in each Contract Package Area, allowing comparison between providers who have been subjected to the same environmental factors (in this case the same regional economic performance).

Second, where outcomes are the result of multiple services – as with re-offending – eliminating attribution risk requires integrated outcome payment schemes. If the Government withholds or divides control of different services that can influence the ultimate outcome, then the cost of capital will be pushed up, since investors have less influence over the results they are paid by. This puts a significant onus on co-commissioning services across different government agencies and departments.

43 Mulheirn and Gough, *More for less*.

For instance, if getting a job is a key determinant of whether or not someone re-offends, then it would be inefficiently costly to seek to pay a provider by results for tackling re-offending if they have no control over employment services available to their clients. Therefore, there is a strong case for the Government to structure the SIB so that there is co-commissioning across the relevant services that are likely to affect the outcome. Done well, commissioning through payment by results can stimulate collaboration. For instance, the Ministry of Justice and the Department for Work and Pensions are co-commissioning joint outcomes of reductions in reoffending and re-employment services.

However, there are also significant barriers to co-commissioning that have stymied many previous efforts at 'joined-up government', such as cultural differences, information sharing issues and different accountability structures. In seeking to co-commission outcomes, there are likely to be tensions between different departments and public agencies as to the division of funding that each should allocate to any cross-cutting SIB.[44] One option for reducing this problem is to direct spending through a separate channel which can invest alongside these other agencies (see below in the next section for further details) or to pool budgets.

Third, the Government can seek to provide useful data on interventions so that information gaps can be closed to reduce **innovation risk** for social investors and commissioners. Proof of concept for public service interventions would go some way to demonstrating that a SIB (if delivered efficiently) could meet cost and quality requirements. At present much of the evidence base and evaluation is gathered and written by providers or would-be providers. However, these organisations have a vested interest in demonstrating the success of these schemes. Therefore, the Government could help by funding and quality assuring the evaluation of different interventions and making that evidence readily available.

44 Simon Parker, Akash Paun, Jonathan McClory and Kate Blatchford, *Shaping up: a Whitehall for the future* (London: Institute for Government, 2010).

Steps in this direction are already being made. In the US, the Washington State Institute of Public Policy is leading the way in evidence-based policy making on early interventions and their social and financial impact. The Impact Reporting and Investment Standards (IRIS) and Global Impact Investing Rating Scheme (GIIRS) have been established to "collect and benchmark financial and social performance data from funds and enterprises globally". This is an initial step towards providing investors with more rigorous data on which to base their investment decisions.

In the UK, a number of initiatives are seeking to achieve this objective. The Centre for Social Impact Bonds in the Cabinet Office aims to help SIBs that are in the development stage by providing better data on unit costs and intervention costs to help prospective commissioners understand the viability of a SIB at an early stage. In addition, an Early Intervention Foundation has recently been established as a social venture following the influential report by Graham Allen MP.[45] The Department for Work and Pensions has established an Innovation Fund to support robust evaluations of SIBs.

The Cabinet Office is also planning to introduce the following to provide better information for potential investors:

- A **single online gateway** about social investment, which includes information about the main actors in the market, job opportunities, and advice on bidding for contracts.
- A **trade association** for social venture intermediaries to raise their profile
- Promote methods of **exchanging stocks** so that social ventures and social investors can be matched easily.[46]
- The Government suggests that **social risk ratings** be established. This would help investors be able to assess financial and social risk and return.

45 See http://www.earlyinterventionfoundation.org.uk/

46 See http://www.socialstockexchange.com/sse/.

Bolstering the evidence base should not be seen as a panacea for the innovation risk problem, as no two interventions will be the same. Such information and evidence is likely therefore only to give a sense of the outcomes achievable and likely costs, but could help reduce the cost of capital for SIBs functioning at scale.

2. FINDING INVESTORS TO SUBSIDISE THE COSTS

In theory, investment into a SIB could come from mainstream investors. But, as discussed above, the economics are such that mainstream investment into prospective SIBs is very unlikely to be forthcoming given the risks and returns likely to be on offer from commissioners. Thus, for the foreseeable future, SIBs are likely to remain reliant on philanthropists and social investors even if risk is minimised in the ways set out above.

Box 3.1. What is social investment?[46]

Investment can be categorised into three broad types:

- **Philanthropic investment**, such as that financing the Peterborough scheme, is purely social, and positive financial returns are not expected. Gearing philanthropic money in this way may allow it to have more impact than conventional grant funding would.
- **Social investment** seeks social or environmental returns alongside financial returns. Typically investors are ready to discount their expectations of financial returns so that social or environmental outcomes are achieved.
- **Conventional investment** is derived from the capital markets and it seeks market rates of return.

47 Disley, Rubin, Scraggs, Burrowes and Culley, *Lessons learned from the planning and early implementation of the Social Impact Bond at HMP Peterborough*, 26-28. See also: http://www.philanthropyuk.org/publications/guide-giving/how-give/social-investment.

Policy makers should consider the role of philanthropic investment in helping get more SIBs underway. A principal distinction should be drawn between **grant giving** (in which a charity expects no return and sacrifices the money in its entirety for the social outcome) and **social investment** (in which an investor seeks a financial as well as social return).

Charitable foundations have a number of primary functions as **grant givers** in building the SIBs market:

- Foundations can operate at the very vanguard of innovation and pay for the extremely experimental interventions which do not have the necessary track record to attract returns-seeking investors. The track record can subsequently pave the way for a viable SIB in that policy area.
- Funders can put grant money in to subsidise or underwrite a SIB. The New York City project to rehabilitate young offenders adopts such an approach, potentially laying the foundations for sustainable social sector interventions. The grant money reduces the downside risk to other investors. Assuming that the project achieves the project outcomes, the grant is retained to be used for future projects (see Box 3.2 below).

Foundations alternatively may pay for feasibility studies or procurement costs.

Box 3.2. Case Study: Philanthropic investment subsidised SIBs

The City of New York project aims to reduce the re-incarceration rate among adolescents at Rikers Island. Bloomberg Philanthropies have provided a $7.2m grant to the intermediary to guarantee a significant portion of a $9.6m investment provided by Goldman Sachs. Goldman Sachs only receive their principal investment back if the re-admission rate is reduced by 10%. Because of the philanthropic subsidy, at worst, Goldman Sachs risks losing a quarter of its principal investment. On the upside, Goldman Sachs will receive a financial return if the number of re-offenders is reduced by 11% or more.

In the event that the SIB works as hoped and that the investment is recouped, the grant will be retained by the intermediary to facilitate future SIBs in the city. The fact that the grant is retained for future projects conditional on the success of the SIB, acts as an additional incentive for providers and the intermediaries to achieve the project outcomes.

However, apart from the fact that relying on soft money will drastically limit the scalability of the SIB model, the theoretical benefits of commissioning through a SIB may also be undermined. The absence of mainstream investors bearing the full risk of the scheme arguably reduces the level of market discipline applied to VCS activities. Mainstream investors bearing outcome risk are likely to hold providers to a much more exacting standard of performance than investors offering capital at sub-market rates. Any subsidy of investment that absorbs project risk will dilute the incentive on the investor (or the intermediary as an agent) to scrutinise and performance manage the VCS provider. This has potential consequences for the competitiveness of the market, the performance of providers and, ultimately, the success of the SIB. In addition, charity funders may be concerned about the ethical issues of subsidising other private investors.

Alternatively, philanthropic foundations can put money into SIBs from their endowments as social investments.[48] The Charity Commission's *Charities and Investment Matters: A guide for trustees (CC14)* established a case for foundations to invest their endowments to achieve a combination of financial and social objectives, although the decision over whether to invest an endowment will also be informed by the trustees' investment policy.[49] Again, foundations can adopt two strategies as investors:

- 'Pari-passu' investment on a like-for-like basis with other investors, thus reducing the amount of additional capital required to get a SIB underway.
- Offer more generous terms for their capital (such as by taking a lower level of the upside or a higher proportion of the downside risk) than other project investors, thus subsidising the project by underwriting losses, taking the first loss of a project, or guaranteeing minimum level returns to other investors.

There is also a significant role for promoting other forms of social investment. In April 2012, the Government established Big Society Capital as an independent financial organisation endowed with £400 million from England's dormant bank accounts and £200 million from the four largest UK high street banks to boost social investment. Subsequently, Big Society Capital has invested £825,000 into the Essex Social Impact Bond alongside seven other investors. Big Society Capital has invested in a total of six SIBs thus far.

48 For instance, in the Peterborough Pilot.

49 Charity Commission, *Charities and investment matters: a guide for trustees* (London: Charity Commission, 2011), http://www.charitycommission.gov.uk/media/93859/cc14text.pdf.

Policymakers are looking at how to promote the social investment market generally. The Treasury announced a review in Budget 2012 looking at financial barriers to social investment. Subsequently, the 2013 Budget announced a 'new tax relief to encourage private investment in social enterprise'.[50] The Government will consult on its proposals in 2013. Tax relief would boost the general market for social investment but would not target SIBs specifically.

3. COMMISSIONERS SUBSIDISING THE COSTS

In the absence of sufficient subsidised external capital, the state must be willing to subsidise the costs if it wants SIBs to expand to achieve the benefits identified earlier. In particular, there may be a role for government to subsidise the costs to early adopters in order to get the SIB 'ball' rolling. The Government may also consider that there are wider social benefits (beyond departmental cashable savings) that justify subsidy. For example, the Greater London Authority and Department for Communities and Local Government 'Homelessness SIB' has been commissioned on the basis of the value of the social outcomes as well as the cashable savings expected through the service, even though the latter will not cover the full costs of the SIB.[51]

The state can subsidise schemes through one of two methods. First, as set out in Model 2, above, the state could finance the project itself. This is the approach taken in the Doncaster Prison rehabilitation pilot. In doing so, the state is offering an implicit subsidy, and can consequently offer a smaller reward than would otherwise be required. For similar reasons a principal intention of SIBs – to encourage the participation of social sector organisations in the competitive process – is unlikely to be achieved unless commissioners are prepared to risk not getting their money

50 HM Treasury, *Budget 2013* (London: HMSO, 2013).

51 Said Business School and the Cabinet Office, *The Social Investment Market: the role of public policy in innovation and execution* (London: HMSO, 2013).

back. A variation on this approach would be for the Government to underwrite a SIB in the same way as it is intending to offer guarantees to investors in infrastructure projects.[52]

Alternatively, if commissioners are unwilling to subsidise providers with public finance, they may need to do so instead by increasing the reward on offer for investors. The Cabinet Office has recently established a £20m 'Social Outcomes Finance Fund'.[53] This fund has been introduced to provide a top-up subsidy so that SIBs can take place where commissioners may believe that the narrow economic case for the government department, agency or local authority in question is insufficient to justify offering adequate reward payments. In comparison to the size of the social investment market, this fund is significant and could potentially have an important impact by subsidising projects. Such a fund, sitting separate from departmental spending, also has additional benefits. The departmental structure of the public finances makes taking this wider view of possible savings difficult for any one department. Often monies spent on an intervention by one public agency lead to savings that accrue to a different part of the public sector. Such fragmented spending means there is little incentive on the first organisation to fund interventions and adds significant complexity to the commissioning of SIBs. Therefore, the Social Outcomes Finance Fund is one route to circumvent this problem, although, given the fiscal pressures, the Government may struggle to build up the Social Outcomes Finance Fund significantly in the near future.

4. BOOSTING READINESS AMONG INVESTEES AND COMMISSIONERS

As we explored in Chapter 2, investee readiness is an issue that needs tackling, and government can help here. For instance, some

52 Gabriella Jozwiak, "Government urged to underwrite social impact bonds", *Children and Young People Now,* May 7, 2013.

53 HM Government, *Growing the Social Investment Market: progress update*

social sector organisations highlighted onerous 'administrative burdens' placed on subcontractors by prime contractors through the early procurement stages of the Work Programme.[54] As the Cabinet Office has recognised, commissioners need to design processes that do not impose burdensome requirements on VCS bidders.

However, as Chapter Two demonstrated, many social sector organisations do not have the business planning skills or financial acumen to seek or win investment. The Government has launched a number of schemes to boost investee readiness for social finance. These include the £10 million Investment and Contract Readiness Fund. This will provide grants to social sector organisations to purchase the capacity building support needed to help raise investment. The Cabinet Office is also pursuing the Inspiring Impact programme which seeks to focus the attention of not-for-profit organisations on impact measurement and unit costs.[55]

Government can also seek to promote SIBs by standardising aspects of their design. The Cabinet Office is currently developing a template contract for the legal aspects of a SIB. This will help to promote connections between commissioners and intermediaries whilst reducing transaction costs.

Finally, attention also needs to turn to how to boost the capability of commissioners. Alongside the reforms set out above there may be a case for incentivising commissioners to share intelligence on their SIB commissioning process with other commissioners.

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54 House of Commons Work and Pensions Select Committee, *Work Programme: providers and contracting arrangements* (London: HMSO: 2011), 19-20.

55 See: http://inspiringimpact.org/our-plan/.

CONCLUSIONS

In the search for productivity improvements in public services, SIBs are an exciting development to be deployed in public service delivery. As the market evolves, there is a wider debate to be had about the potential scope for SIBs. Two particular scenarios present themselves.

In the first scenario, SIBs could always operate on the **frontier** of innovation and intervention risk. As soon as there is a greater level of certainty about the effectiveness of an intervention it could be procured through a cheaper and more standardised commissioning method. Commissioners could then shift to pay by outcomes at the next frontier of service innovation. Under this model, SIBs would always be heavily subsidised by government or philanthropists. Consequently, the danger is that the market signals that underpin the theoretical case for SIBs are so blunted that the model fails to have the desired innovative impact.

Alternatively, SIBs could be used as a **mainstream** commissioning structure. But for this to happen, a great deal of action needs to be taken to close the risk gap between the returns that would-be investors demand, and the price that commissioners are prepared to pay. Unless they can be done at scale it may never be possible to close the risk gap.

It is too early to say which of these distinct roles SIBs could ultimately play in the commissioning of public services. Greater clarity from government and advocates would therefore help to set the destination for this agenda. But, in either case, it is clear that for SIBs to have a meaningful impact on delivery there are a range of important barriers that require concerted attention from policymakers. Taking steps to resolve the problems will be a long game – we should start now.

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