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Philanthropy

Presentation slides will be available at June 4, 2014 Commission meeting.

Background

Given the current environment of limited government budgets and strained philanthropic dollars, the concept of "social innovation financing" is gaining momentum as a way to finance proven service programs, fund what works, and drive government accountability. The following summaries cover recent papers on Social Innovation Bonds. The first, *Foundations for Social Impact Bonds*, is attached in its entirety for Commissioner's review. The second, *A Technical Guide to Social Impact Bond Development*, is available on request.

What is a Social Impact Bond?

A Social Impact Bond (SIB) is a financing mechanism designed to raise private-sector capital to expand effective social service programs. They are a way to finance pay-for-success contracts, which allow governments to pay only for results. If a program funded by an SIB achieves successful outcomes, which are defined and agreed upon in advance by all parties to the contract, government repays investors their principal plus a rate of return based on the program's success. If outcomes are not achieved, government is not obligated to repay investors.

Four Social Impact Bonds are now in place in four locations in the United States: New York City, Utah, New York State, and Massachusetts.

See page 9 of the Foundations for Social Impact Bonds paper for a more detailed description.

Paper 1: Foundations for Social Impact Bonds

This paper provides a summary of interviews conducted with staff at foundations who are involved with social financing at all stages of engagement with the market – from observers to the actively involved. It is intended to provide shared learning about this relatively new concept for funding programs and services that bring about social change.

The study found that foundations are highly interested in Social Impact Bonds because of their ability to:

- shift funding from remediation to prevention;
- focus on outcomes;
- encourage government efficiency;
- foster collaboration; and
- amplify impact.

Shift Funding Toward Prevention

It is well-known that a significant amount of government resources are allocated toward remediation rather than prevention. With SIBs, preventative services are designed to eliminate or vastly reduce the need for future spending on treatment services downstream, thereby allowing the redirection of a revenue stream that enables government to repay investors.

Focus on Outcomes

SIBs require the government and social sector to identify outcomes, rather than outputs (e.g., graduation rates vs. completion of a program that supports graduation). SIBs are results-based, rather than financing a specific quantity or set of services, which allows for a more comprehensive approach to complex problems.

Encourage Government Efficiency

Because SIBs allow government to pay only for results, they encourage greater efficiency within the public sector. Payments are determined by data, which assures the public sector it is getting real value for its money.

Foster Collaboration

By definition, SIBs draw together stakeholders including government agencies, private-sector investors, service providers, beneficiaries, and intermediaries, all working toward a shared purpose. If the parties want the SIB to launch and succeed, they have to reach consensus at the outset and maintain consensus over the life of the project. This results in a system of checks and balances that prevents any party's self-interest from undermining the pursuit of shared objectives – yielding significantly greater progress at reduced expense.

Amplify Impact

The ability to raise a significant new stream of funds allows service providers to scale up their programs and reach many more individuals.

Challenges

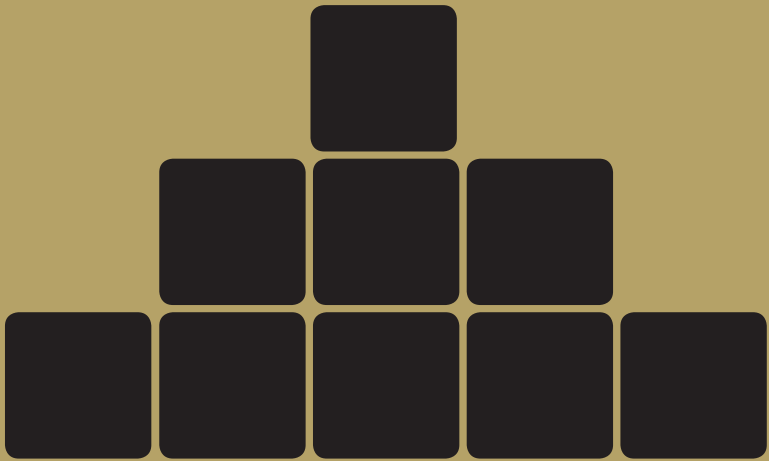
Despite their promise, there are challenges to widespread use of Social Impact Bonds. There is a steep learning curve and lack of precedent on which to base transactions. There is a built-in complexity as a result of the need to align the interests of multiple sets of stakeholders. Silos across levels within government and agencies may create a barrier to collaborations, and divisions within foundations between grant-making and investment sides may also impede investment deals. Finally, the lack of standardized, high quality data on the impact of social programs may present obstacles, with weak data leading to unintended consequences and the misallocation of resources.

Paper 2: A Technical Guide to Social Impact Bond Development

This paper provides a step-by-step description of the mechanics of Social Impact Bonds. It includes discussion about how an SIB is structured, including investors, a Board of Directors, and Outcomes and Service Contracts. It also provides a detailed analysis of the process of developing a Social Impact Bond, including:

- Assessing the service area that needs reshaping;
- Defining the social issue(s);
- Defining the outcome metric(s);
- Defining the intervention(s);
- Creating the "value-for-money" case, which develops a financial model to assess potential savings as a result of the intervention;
- Program design (the operating plan);
- Procurement (of the SIB-funded service); and
- Contracting (the SIB contract, government arrangements, marketing to investors, and service providers secured).

SOCIAL FINANCE Mobilizing Investment Capital to Drive Social Progress



Foundations for Social Impact Bonds

How and Why Philanthropy Is Catalyzing the Development of a New Market

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PERSHING SQUARE FOUNDATION

Rockefeller Foundation
Innovation for the Next 100 Years

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Acknowledgements

This report reflects the contributions of many people.

First and foremost, we would like to thank all of the individuals who took the time to share their perspectives on this new market with us. Their thoughtful observations provided significant insight into how philanthropy perceives this space.

Second, those with whom we shared initial drafts provided astute guidance, which we strived to reflect in the following pages. In particular, we would like to thank Nancy Barrand, Peter Berliner, Paul Brest, Phil Buchanan, David Carrington, Shawn Cole, Kristina Costa, Alnoor Ebrahim, Michael Etzel, Ian Galloway, Steven Godeke, John Goldstein, Jacob Harold, Alisa Helbitz, Simon Jawitz, Georgia Levenson Keohane, Woody McCutchen, Mario Morino, Sonal Shah, Nadya K. Shmavonian, Laura Tomasko, and David Wood.

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Finally, we are grateful to the Rockefeller Foundation, Omidyar Network, and The Pershing Square Foundation for their financial support of this report. We deeply appreciate the guidance and wisdom of Kippy Joseph, Amy Klement, and Paul Bernstein.

Any errors or omissions are ours alone.

This paper was written by Jane Hughes and Jill Scherer.

Table of Contents

Foreword

Rockefeller Foundation
Innovation for the Next 100 Years

For the past century, The Rockefeller Foundation's mission to promote the well-being of humanity has been marked by a strong commitment to both innovation and collaboration to solve some of the world's most pressing challenges, whether it was developing a vaccine for the yellow fever outbreak of the early 20th century or the Green Revolution that fed more than a billion people in Latin America and Asia. The challenges of our 21st century world call for no less—particularly as crises continue to outpace our best responses.

Private markets are needed to find and finance forward-looking solutions—and philanthropy is well-suited to help engage new capital, by peeling back the first layer of risk and developing the infrastructure for innovative finance to take root. This is why The Rockefeller Foundation has been an early innovator and funder of the ecosystem for Social Impact Bonds (SIBs), an innovative finance mechanism aimed at scaling social interventions to deliver a measurable benefit for society. From early support for Social Finance UK and the pilot SIB program in Peterborough, UK, the Foundation has committed itself to facilitating the development and testing of this innovative finance model.

Although SIBs are a relatively new tool, it has rapidly garnered support as an innovative approach to financing valuable social programs without putting taxpayer dollars at risk. SIBs are marching closer to achieving "proof of concept," at which point, the sustaining market for SIBs will no longer require philanthropic capital.

But until then, philanthropy will continue to play a pivotal role. Over the last three years, The Rockefeller Foundation has helped to build the SIB ecosystem in the United States by providing planning grants to intermediaries and service providers; funding research focusing on political trajectories, the investor landscape, and social applications; and supporting first-mover mayors' and governors' offices to increase their capacities to negotiate, structure, and execute bonds.

Philanthropy is now looking to the future by exploring possible adaptations of the SIB model to environmental and international development causes. We hope that by collecting and sharing the experiences of various foundations and partners, this report will serve to accelerate the innovation and further development of SIBs for the benefit of the poor and vulnerable, and for the well-being of all humanity, throughout the world.

Judith Rodin

Judith Rodin
President, The Rockefeller Foundation

When John D. Rockefeller created the Rockefeller Foundation in 1913, he never envisioned the innovations of impact investing and Social Impact Bonds (SIBs) that his successors are supporting a hundred years later. His core message, however, lives on: Philanthropy should be deeply engaged as a laboratory of research and development for new paths of social innovation.

My colleagues interviewed thought leaders at 30 different foundations and organizations for this study in order to gather their stories and early experiences for the benefit of the broader philanthropic community. Within this limited sample, they found widespread agreement around the role of foundations in testing innovations such as SIBs. Over and over, foundation program officers and executives remarked on their institutions' willingness and ability to take on risks in support of SIB initiatives, and to seed the emerging market through its early, uncertain stages.

We at Social Finance are deeply cognizant of—and profoundly grateful for—the backing of philanthropic organizations in laying the foundation for the development of the SIB market. Indeed, it would not exist today without the support of these organizations. The first SIBs in both the US and UK were launched thanks to the support of foundations. Most recently, foundation support was vital in the two transactions announced in winter 2013-14 in Massachusetts and New York State, both of which feature substantial participation from major foundations.

At nearly $50 million, the US SIB market is now the largest in the world. Yet, this market is still far from maturity—and still, accordingly, dependent upon foundations that are willing to take on the risks of developing this high-beta, early-stage innovation. Foundations are uniquely capable of taking a long-term view by providing the patient capital that is essential to advancing the use of this innovative financial tool. Moreover, foundations provide much more than money; the thought partnership and intellectual capital that they bring to the table are equally important in shaping the SIB market.

What can philanthropy do now to accelerate progress and drive the development of a standardized, widespread SIB market in the US? And how will the role of foundations evolve as the market evolves? If the role of foundations is to incubate new initiatives, then who expands on their work once the incubation period is over? Is there an exit strategy for foundations, after they have laid the groundwork for a sound and stable SIB market by helping to build an ecosystem, refine the concept, and unlock capital? Or will they remain involved in an advisory capacity, lending their knowledge, integrity, and credibility?

This study sets out to explore philanthropy's role as innovator, funder, investor, and advisor in the SIB market, by drawing on Social Finance's on-the-ground experience as well as the rich and varied contributions of our interviewees and reviewers. We are greatly indebted to those who so generously lent their time, expertise, and wisdom to our work.

We look forward to your feedback and shared learnings.

Tracy Palandjian
CEO, Social Finance, Inc.

Executive Summary

THE US SIB MARKET HAS EVOLVED SWIFTLY FROM CONCEPT TO LAUNCH—DUE IN LARGE PART TO THE CATALYTIC SUPPORT OF FOUNDATIONS.

The provision of social services in the United States has entered a new era marked by two powerful forces: mounting pressure on government and philanthropic resources, and innovation in the social sector. These trends are intertwined; high demand for social services in combination with strained budgets call for innovative approaches to complex social challenges and new ways to finance them. Social innovation financing, especially Social Impact Bonds (SIBs), has emerged as a promising way to finance proven social services programs, fund what works, and drive government accountability.

The US SIB market has evolved swiftly from concept to launch—due in large part to the catalytic support of foundations. What has driven foundations to engage with this new form of social-sector financing? What roles have they undertaken, and how do they view their experience so far? Based on our on-the-ground experience as well as interviews with staff at foundations at all stages of engagement with the market—from observers to the actively involved—we set out to explore these questions in the context of the US market.

Our research indicates that the foundations that have chosen to engage with this nascent market are doing so for a number of reasons and in a variety of ways. They are attracted to the tool's potential to shift funding from remediation to prevention, focus on outcomes, encourage government efficiency, foster collaboration, amplify impact, and deploy capital through program-related investments (PRIs). Many viewed foundation engagement with SIBs as a natural outgrowth of philanthropy's traditional role as an "idea shop" that may take on the risk of proving a concept before it can be scaled by government.

Foundations are choosing multiple channels of engagement. They are supporting the creation of a SIB ecosystem and building a track record for this new tool by:

- ***Making grants*** *to support capacity building among key market participants, conduct research and encourage learning, develop proof-of-concept projects, pay for outcomes, and mitigate risk.*
- ***Investing*** *directly in SIB transactions through PRIs, recoverable grants, and other forms of investment.*

- ***Fostering partnerships*** *among stakeholders by helping to bring together the various and diverse actors in this space, and helping to unite them around shared goals.*

- ***Advocating and educating*** *to influence policy, attitudes, and knowledge, both among the general public and among those directly involved in SIBs, such as government officials and service providers.*

Despite the wealth of activity, substantial challenges remain before the potential of SIBs evolves into the reality of a self-sustaining market. Foundations entering the market are likely to encounter a steep learning curve and a lack of precedent on which to base transactions. Many interviewees expressed concern with the slow progress and unexpected complexity encountered in developing early SIB transactions in the US. Extra effort is required to align the interests of multiple sets of stakeholders. Silos within government across levels (local, state, national) and agencies may further stymie collaboration, while divisions within foundations between the grantmaking and investment sides may impede investment in deals. A lack of standardized, high quality data on the impact of social programs may also present obstacles. Weak data, for instance, could lead to unintended consequences and the misallocation of resources.

Finally, our interviews revealed substantial uncertainty around the long-term vision for SIBs. Specifically, foundation staff questioned how long the market would require philanthropic support and whether the ultimate goal was to hand off social services financing to mainstream impact investors[1] or government. There was much debate over the costs and benefits of credit enhancements in early SIB transactions. Some argued that philanthropy should help to seed the nascent market, but should then seek to hand off SIBs to mainstream impact investors as the market matures. Others believe that foundations bring much more to the market than just capital—they bring knowledge, integrity, and credibility—and thus should remain engaged for the long term.

Indeed, foundations may play a vital role in building a stronger market ecosystem by helping to educate market participants, including government and service providers, on the nuances of SIBs. As widely respected institutions, they are well-positioned to encourage the adoption of better data systems and urge for transparency in SIB contracts and outcomes, which are critical elements in building the industry. Foundations can also draw upon their extensive experience in the social sector to steer the conversation about how pay-for-success strategies can be adapted in different contexts to achieve better results. They can use their deep knowledge of both issue-area research and program operations to provide insight into best practices, and to ensure that individual SIB transactions maximize the opportunity to serve the public good.

Over the near term, the willingness of philanthropic institutions—large and small, corporate, national and community-based—to encourage experimentation and create the building blocks for this new market may go a long way toward realizing its potential: bringing effective programs to many more individuals in need. Further out, foundations may exit the market as the funding of proven social programs increasingly gets taken up by investors or the government. Alternatively, it is possible to envision a future in which mainstream impact investors, governments, and foundations continue to co-fund some SIB transactions for interventions with broad social benefits that may be difficult to monetize. This arrangement would underline the core strength of the SIB model: its ability to facilitate multi-sector, multi-partner collaboration to generate both social and financial benefits.

1 *"Mainstream impact investors" in this context refers to institutional investors and high net-worth investors and family offices that make investments to generate financial returns and intentionally improve social or environmental outcomes.*

What Is a Social Impact Bond?

A Social Impact Bond is an innovative financing mechanism designed to raise private-sector capital to expand effective social service programs. SIBs are a way to finance pay-for-success contracts, which allow government to pay only for results. If a program funded by SIBs achieves successful outcomes,[2] which are defined and agreed upon in advance by all parties to the contract, government repays investors their principal plus a rate of return based on the program's success.[3] If outcomes are not achieved, on the other hand, government is not obligated to repay investors.

As currently conceived, SIBs are only appropriate for specific problems that meet key criteria. A project is a good candidate for SIB financing if the issue area falls within a policy priority for the participating government and the project has:

- *Strong and committed government leadership with the will and ability to champion the project;*
- *Proven interventions delivered by experienced service providers with the ability to scale up their work;*
- *Potential for high net benefits, such that the anticipated benefits from the program justify the costs of implementation;*
- *Robust data availability and analysis, enabling credible outcomes measurement in a reasonable timeframe, based on a well-defined population of sufficient sample size; and*
- *Safeguards against unintended adverse consequences.*[4]

SIBs are one tool within the wider impact investing market, which offers the potential to draw large sums of private capital to the effort of solving complex social problems. By leveraging a new source of capital to fund social services, impact investing tools like SIBs provide an opportunity to accelerate progress on longstanding issues by scaling up effective programs to reach many more people in need than would be possible through grant or government dollars alone. For foundations that make mission- or program-related investments, this impact can be even more powerful as foundations are able to recycle their capital into other projects to support their missions.

Like other impact investments, SIBs involve the participation of investors who bring market discipline to transactions. Similar to many foundations, these investors conduct due diligence to ensure that participating service providers have a track record of positive results, the management capacity to grow their operations successfully, and a culture of collecting and using data to improve performance. During the course of the project, investors expect intermediaries to provide ongoing performance management and implement midcourse corrections as needed. Further, they require that decisions surrounding repayment be based on accurate social and financial data and transparent performance metrics. Their attention to performance management and tangible, quantifiable evidence drives improved outcomes.

Despite their name, Social Impact Bonds differ from municipal bonds and other fixed-income tools that are often used for infrastructure or other capital projects. SIBs share features of both debt and equity. The instrument has a fixed term and the upside is capped, but, like equity, returns vary based on performance and investors bear a higher risk of losing their principal. Moreover, these investments are not secured by hard assets or cash flows. Despite the dissimilarity to typical bonds, SIBs do in fact possess a number of bond-like characteristics, and it is worth noting that bonds are hardly uniform instruments—they come with different features, from zero-coupon bonds to convertible bonds. Similarly, the structure of each SIB will likely vary from project to project.

2 Historically, government payment to service providers has been based on outputs rather than outcomes. The metrics associated with outputs usually focus on head count, for example the number of people enrolled in a program or the number of families served. Outcomes measurement, by contrast, focuses on the impact of the service with regard to achieving desired benefits, such as the reduction in prison recidivism or the number of people who gain long-term employment as a result of the program.

3 For more information about SIBs, please see the list of resources in Appendix II.

4 Jeffrey Liebman and Alina Sellman, "Social Impact Bonds: A Guide for State and Local Governments" Harvard Kennedy School Social Impact Bond Technical Assistance Lab (June 2013), available at http://hkssiblab.files.wordpress.com/2012/11/social-impact-bonds-a-guide-for-state-and-local-governments1.pdf.

Introduction

SOCIAL INNOVATION FINANCING, ESPECIALLY THE SIB, HAS EMERGED AS A PROMISING WAY TO SCALE PROGRAMS AND REACH GREATER NUMBERS OF INDIVIDUALS IN NEED.

Are Social Impact Bonds the Same as Pay For Success?

SIBs are sometimes equated with pay-for-success (PFS) contracts, but the terms are not synonymous. In fact, PFS refers to a type of contract between government and another entity in which pay is linked to performance. The government may promise to pay a service provider when it places an individual in a job and when this person is still at the job for a year; this is a PFS contract, since pay is contingent upon performance. A SIB, by contrast, is a financing mechanism that supports PFS contracts; the SIB is used to provide upfront funding to service providers engaged in PFS contracts. All PFS-based financing arrangements in the social sector, including SIBs, fall under the wider umbrella of social innovation financing.

Governments at all levels are confronting a new era of scarcity. Coping with the lingering effects of the recession, many states and localities are struggling to meet even the essential needs of their citizens. Governments are facing tough choices between making longer term investments in preventative programs and having adequate funds to focus on near-term challenges.[5] And there is no end in sight: experts predict that federal, state, and local governments will face growing fiscal pressures for the foreseeable future.[6] While philanthropy can help, it too faces substantial funding pressures, and cannot meet the large and growing social needs.

The good news is that innovation in the social sector is flourishing. Social entrepreneurs are crafting new approaches to complex social challenges, and an increasing focus on evaluation and data is producing greater knowledge of what works, what may not work, and why. A growing cadre of investors interested in generating social impact alongside financial return is directing substantial new resources to the sector. Within this sphere, social innovation financing, especially the SIB, has emerged as a promising way to scale programs and reach greater numbers of individuals in need.[7]

The speed with which the SIB market has progressed reflects broad interest in SIBs as one way to address current challenges in financing social services. Although the world's first SIB was launched in 2010 in the UK, additional SIB-financed projects have been initiated or are in the pipeline in a number of US locations, such as California, Connecticut, Illinois, Massachusetts, New York, Ohio, South Carolina, Texas, and Utah. Much of this progress can be traced to the catalytic role that foundations are playing in the development of the nascent market.

5 States, for example, have increasingly relied on spending cuts to balance budgets. Between 2008 and 2012, state budget gaps led to a cumulative $290 billion in across-the-board spending cuts in health, education, and human services. By fiscal year 2012, most states were spending less in real terms than they did in 2008, even though the cost of services had increased. Source: Center on Budget and Policy Priorities, "Out of Balance: Cuts in Services Have Been States' Primary Response to Budget Gaps, Harming the Nation's Economy" (April 2012), available at http://www.cbpp.org/cms/index.cfm?fa=view&id=3747.

6 United States Government Accountability Office, "State and Local Governments Fiscal Outlook: April 2013 Update," available at http://www.gao.gov/assets/660/654255.pdf.

7 While we acknowledge that SIBs may be used to finance new and untested approaches to social challenges, Social Finance believes that the appeal of SIBs lies in their ability to finance the scaling-up of evidence-based interventions. It is important to underscore that SIBs do not replace government spending for social services; rather, they can redirect government spending toward what works. Even when supporting interventions with a track record of success, however, SIBs carry the risk of poor execution related to the scaling-up process itself.

Public and private foundations—those non-governmental organizations established to make grants for charitable purposes—are helping to build the market's infrastructure and demonstrate the tool's capacity. The Rockefeller Foundation invested in the first SIB in the UK and has since made a number of grants in support of building the US market. Bloomberg Philanthropies provided credit enhancement for a SIB in New York City and as a result helped attract the participation of commercial capital. Other foundations are providing operating capital to market intermediaries, funding demonstration projects, and developing deals alongside government officials.

What has driven foundations to engage with this new form of social-sector financing? What roles have they undertaken, on page 13 for a description of this paper's methodology). Our goal was to collect the early learnings of these pioneers for the benefit of the broader philanthropic community.

This paper is intended for foundation staff, board members, and donors who are interested in this innovative approach to channeling more resources to evidence-based programs, as well as other stakeholders looking to learn about the various ways that foundations may support the market.

We begin by summarizing the current state of foundation engagement in the US SIB market, primarily based on findings from our interviews with a number of foundation staff members. In this section, we explore why foundations

THE SPEED WITH WHICH THE SIB MARKET HAS PROGRESSED REFLECTS BROAD INTEREST IN SIBS AS ONE WAY TO ADDRESS CURRENT CHALLENGES IN FINANCING SOCIAL SERVICES.

and how do they view their experience so far? What are their concerns? How long will philanthropy play a role in the SIB market? Based on our on-the-ground experience as well as interviews with staff at foundations at all stages of engagement with the market—from observers to the actively involved—we set out to explore these questions in the context of the US market.

It is important to note that our interviews were primarily with staff at those foundations that have already begun to explore social innovation financing and therefore do not reflect a random sample of philanthropic organizations (see the sidebar

have chosen to support this market, and how they have engaged. Based on the roles foundations have played to date, we provide a menu of options for other foundations that may be interested in getting involved. Next, we delve into some of the concerns that foundations may have about SIBs, as well as the obstacles that foundation staff and boards may encounter as they move into the market. We end the paper with reflections on the way forward, including our thoughts on how to optimize foundation participation to build a robust and self-sustaining SIB market in the US.

Methodology

In our research for this paper, we leaned heavily upon the previous work of others who have studied this field and in-depth interviews with over two dozen foundation staff members and leaders in the nonprofit sector, as well as our own observations as an active participant in the development of the US SIB market. (See Appendix I for a list of our interviewees.) We endeavored to interview staff at foundations at all stages of engagement with the SIB market—from observers to the actively involved; however, our sample is heavily weighted toward those foundations that have already begun to explore this approach. We also strived to include foundations of different sizes, from opposite corners of the country, and supporting a variety of mission areas. In the end, however, the information that we gathered from these interviews is anecdotal rather than scientific—a varied assortment of opinions rather than a random sample—and we are careful to treat it as such. As one of our interviewees observed, "If you know one foundation, you know one foundation."

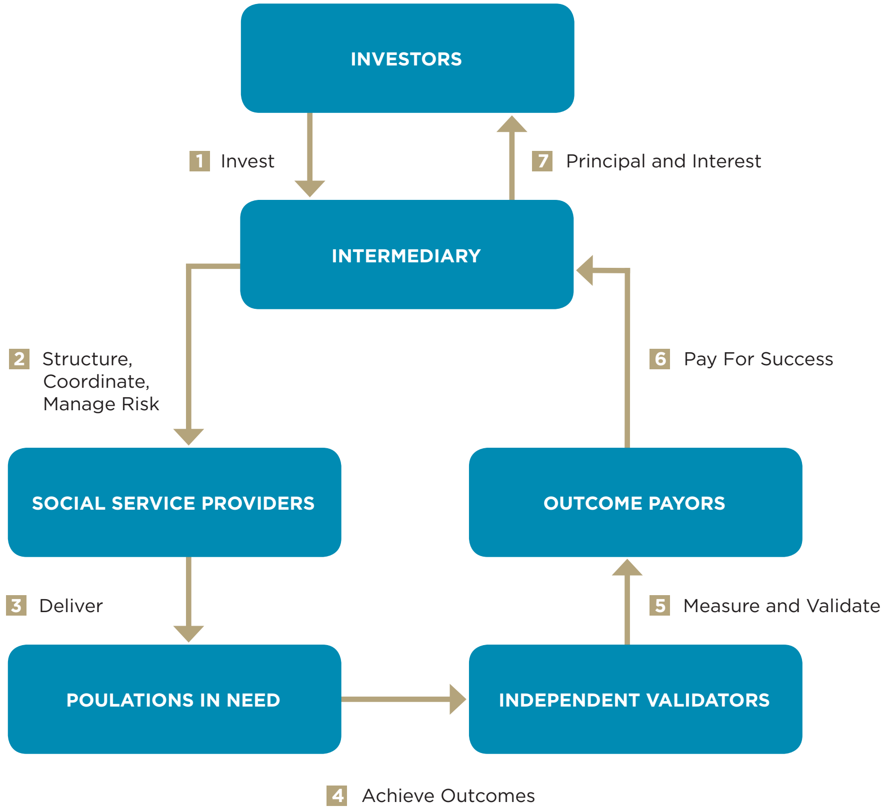
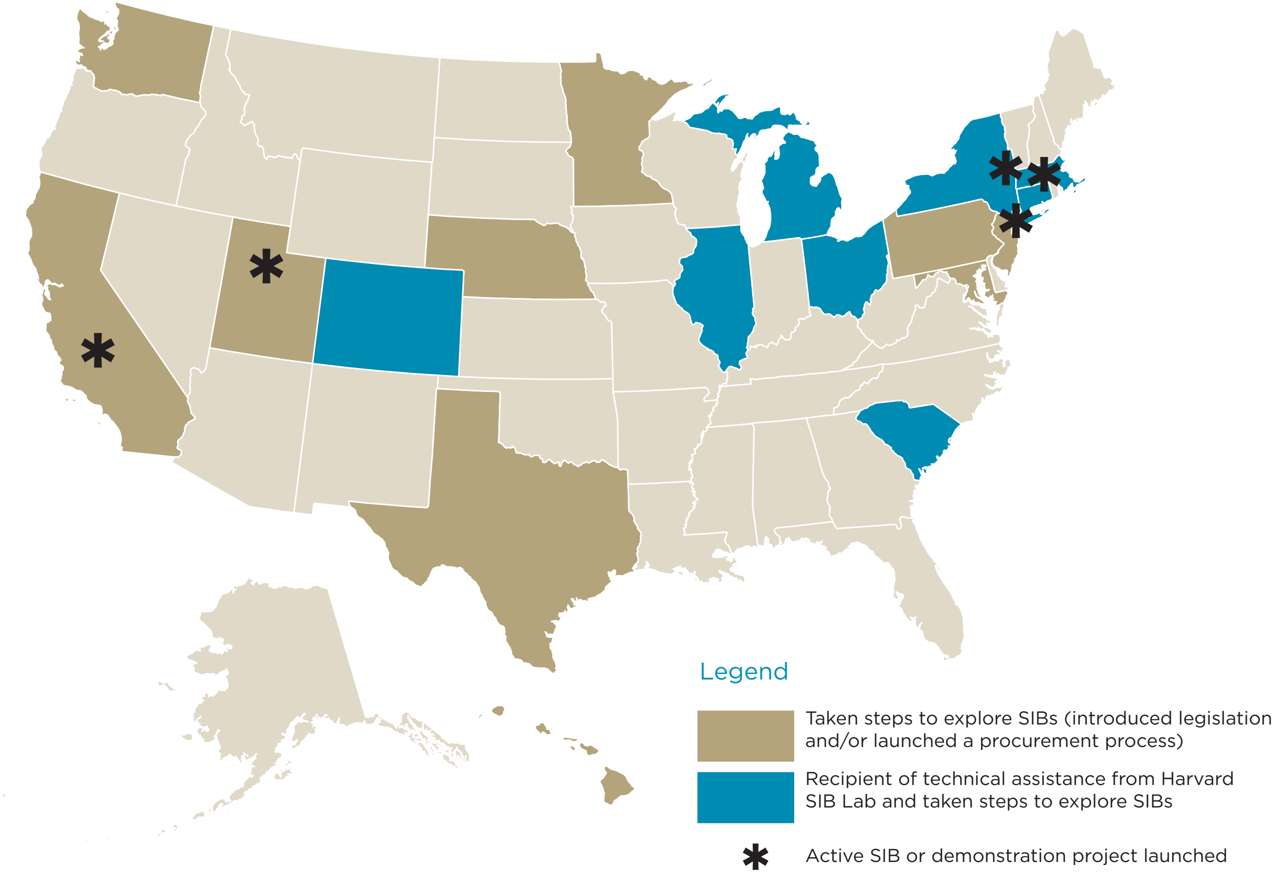


Figure 1. **How a Social Impact Bond works**

WHAT HAS DRIVEN FOUNDATIONS TO ENGAGE WITH THIS NEW FORM OF SOCIAL-SECTOR FINANCING? WHAT ROLES HAVE THEY UNDERTAKEN, AND HOW DO THEY VIEW THEIR EXPERIENCE SO FAR?



Accurate as of date of publication.

Figure 2. **Social Impact Bond activity across the United States**

ALTHOUGH THE WORLD'S FIRST SIB WAS LAUNCHED IN 2010 IN THE UK, SIB-FINANCED PROJECTS ARE IN THE PIPELINE ACROSS THE US. MUCH OF THIS PROGRESS CAN BE TRACED TO THE CATALYTIC ROLE THAT FOUNDATIONS ARE PLAYING IN THE DEVELOPMENT OF THE NASCENT MARKET.

Today’s Social Impact Bond Market

The worldwide SIB market was born in the fall of 2010 in the UK, when Social Finance UK launched the first SIB. The SIB-financed program aims to reduce re-offending among men who are released from Peterborough Prison. Experienced social sector organizations will provide intensive support to 3,000 short-sentenced prisoners over a 6-year period, both inside the prison and after release, to help them resettle into the community. If this support reduces re-offending by less than 7.5 percent, the government will not repay investors. If it delivers a drop in re-offending beyond 7.5 percent, investors will receive an increasing return of up to 13 percent based upon the program’s success in achieving social outcomes. Investors in the Peterborough SIB are foundations, including the Rockefeller Foundation, and philanthropic-minded individuals and families. Since launching the Peterborough SIB, the UK has remained very active in worldwide SIB development, with more than a dozen on-the-ground projects.

Pilots in the US have emerged more recently. In 2013, New York City became the first American jurisdiction to launch a SIB, and three additional deals have since been announced. The four SIBs that are now on the ground in the US are:

- ***New York City.*** *A $9.6 million project, this SIB directs capital from Goldman Sachs to a program that aims to reduce recidivism among young men exiting the Rikers Island corrections facility.*

- ***Utah.*** *Philanthropist J.B. Pritzker and Goldman Sachs are channeling up to $7.0 million to increase enrollment in a high-quality preschool program in order to reduce the need for special education and remedial services.*

- ***New York State.*** *Over 40 individual, philanthropic, and institutional investors are providing $13.5 million in funding to expand access to a workforce development program for formerly incarcerated individuals in order to boost their employment rates and reduce repeat incarceration.*

- ***Massachusetts.*** *Financed by $18 million in commercial and philanthropic funding, this SIB scales up a program delivered by a local service provider, Roca, to reduce recidivism and improve employment outcomes for young men at high risk of reoffending.*

Altogether, these deals are channeling approximately $50 million in private capital to the social sector, making the US the largest SIB market in the world in dollar terms. A number of other state and local governments are at various stages of exploring SIBs. At the federal level, President Obama has put forth support for pay-for-success initiatives in each of his budgets since 2011. The President’s 2014 budget also proposed a new $300 million Incentive Fund at the Department of the Treasury to help state and local governments implement pay-for-success programs.

In addition, SIBs have commanded attention globally. In June 2013, UK Prime Minster David Cameron convened leaders from G8 member states for a Social Impact Investment Forum. Senior politicians, major philanthropists, leading investors, entrepreneurs, and business executives met to discuss the opportunities and challenges of a global impact investment market, and much discussion focused on SIBs.

Findings: Foundation Engagement with the SIB Market

FOUNDATIONS THAT FIND SIBS APPEALING AND WORTHY OF EXPLORATION HAVE A MENU OF OPTIONS FROM WHICH TO CHOOSE. BROADLY, FOUNDATIONS CAN SUPPORT SIBS IN FOUR WAYS: THROUGH GRANTMAKING, INVESTMENTS, PARTNERSHIPS, AND ADVOCACY.

The foundation staff interviewed for this paper highlighted the significant potential that many of them see in SIBs, ways that foundations may add value to the market, and challenges that may impede further activity. The next few sections provide insight into how foundations view the nascent market.

WHY ENGAGE?

Our conversations with a number of foundations point to a substantial level of support for the SIB concept. One interviewee called SIBs an "emerging jewel," while many expressed support ranging from "guarded" to "enthusiastic" for SIBs' potential to drive the expansion of evidence-based social interventions. Many were drawn to the ability of SIBs to provide flexible, patient capital at scale. Foundations that are supporting the development of the SIB market explained their reasons for participation, while others identified what they saw as the tool's most appealing characteristics.

Shift Funding toward Prevention

Many foundations are keenly aware that a significant amount of government resources are allocated toward remediation rather than prevention, and are eager to reverse this trend. The recent recession has forced many governments to make tough spending cuts, often sacrificing investments in programs that produce long-term results to ensure sufficient funds for near-term needs. As one interviewee noted, some governments have not had "the luxury of taking the future into consideration."

Several of our interviewees cited SIBs' emphasis on funding preventative programs as an appealing characteristic; as Frederick Douglass once said, "It is easier to build strong children than to repair broken men." A SIB-financed program has the potential to tackle the root causes of problems rather than just treating their symptoms. For example, a SIB targeting a reduction in asthma could finance asthma management education and the removal of home environmental triggers to reduce the need for emergency medical treatment. Indeed, the focus on prevention is really the financial engine that drives the SIB. Preventative services are designed to eliminate or vastly reduce the need for future spending on treatment services downstream, redirecting a revenue stream that enables government to repay investors.

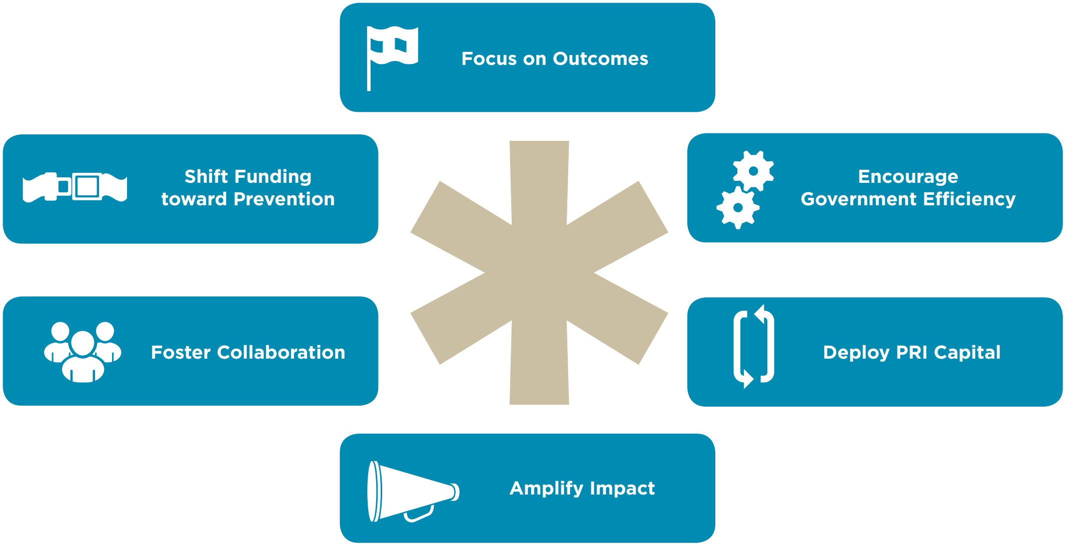


Figure 3. **Why foundations are engaging with Social Impact Bonds**

As one interviewee noted, the values of funding prevention and promoting government efficiency are not new concepts. But SIBs "raise the stakes," since actually accomplishing these objectives is no longer "a good idea or aspiration—real money is on the line."

Focus on Outcomes

SIBs' focus on outcomes was another oft-cited benefit. This focus aligns with growing interest from government, philanthropy, and the social sector in data collection, evaluation, and performance-based contracting. One interviewee commented that SIBs' "hard-nosed" approach—only rewarding what works—aligns with her foundation's interest in expanding evidence-based practices in the social sector. Because they focus on results, SIBs are not prescriptive, noted another interviewee; instead of financing a specific quantity and set of services, they allow for flexibility in service provision. This allows for "a more comprehensive approach to complex problems." An intermediary may coordinate multiple services for clients in order to meet their needs and achieve target outcomes. SIBs also commit the government and social sector to think about assessing outcomes, such as high school graduation rates, beyond the more common practice of measuring outputs, such as program completion.

Moreover, SIB-financed projects incorporate a strong component of performance management. Intermediaries and service providers manage the project closely, evaluating data on a regular basis and implementing midcourse corrections as needed. In this way, projects can evolve and adapt in order to deliver the greatest benefits.

Some foundations perceive the focus on outcomes as an important development in the social sector. They are looking beyond SIBs to the broader field of pay-for-performance. For instance, the Kresge Foundation believes that pay-for-performance structures may play an important role in service delivery going forward. To test the efficacy and efficiency of different structures, it is involved in a pilot set of pay-for-performance transactions that tie directly to the foundation's programmatic interests.

Encourage Government Efficiency

Because SIBs allow government to pay only for results, they encourage greater efficiency within the public sector. Despite growing attention to evidence in the social sector, historical funding patterns, legacy interests, and short political cycles often impede the reallocation of public dollars to the most effective interventions. Several of our foundation interviewees cited the potential of SIBs to increase accountability for taxpayer dollars. SIBs allow governments "to buy a result rather than a process," noted one interviewee. Where payments are determined by data, the public sector is assured of getting real value for its money.

This holds potential for governmental work beyond SIBs. As government officials become comfortable with the concept of pricing social outcomes, they may be more likely to incorporate outcomes data into decision-making over a broad range of areas. This should encourage efficiency by emphasizing the value of prevention over remediation, facilitating cost-benefit analysis of various interventions, and encouraging government to make evidence-based funding decisions.

Foster Collaboration

Many of our interviewees also viewed with great favor the ability of SIBs to promote collaboration; one commented, "Foundations really like to partner." By definition, SIBs draw together a number of stakeholders—government agencies, private-sector investors, service providers, beneficiaries, and intermediaries—working toward a shared purpose.

While SIB-financed projects foster cross-sector collaboration, they also have the potential to enhance the quality of these collaborations. Not only does a SIB assemble various stakeholders, but its success requires close and collegial cooperation among them. Any SIB involves internal tensions among stakeholders, and a successful transaction requires that stakeholders' incentives are aligned. In fact, each party effectively has a veto over every aspect of the enterprise. If any of them exercises that veto during the design phase, the SIB will not launch; if any of them does so during implementation, the SIB will not work. If the parties want the SIB to launch and to succeed, they have to reach consensus at the outset and maintain consensus over the life of the project.

This dynamic tension is the reason that SIBs have the potential to produce significantly greater social progress at substantially reduced expense. The system of checks and balances under the umbrella of the SIB partnership prevents any party's self-interest from undermining the pursuit of shared objectives, and keeps the partners' diverse interests in alignment.

INDEED, THE FOCUS ON PREVENTION IS REALLY THE FINANCIAL ENGINE THAT DRIVES THE SIB. PREVENTATIVE SERVICES ARE DESIGNED TO ELIMINATE OR VASTLY REDUCE THE NEED FOR FUTURE SPENDING ON TREATMENT SERVICES DOWNSTREAM, REDIRECTING A REVENUE STREAM THAT ENABLES GOVERNMENT TO REPAY INVESTORS.

For example, a government participating in a SIB may agree to a performance benchmark that incentivizes key stakeholders in the following ways:

- *The benchmark is within reach of the participating service provider, making it more likely that investors will be repaid.*

- *The benchmark is high enough to create meaningful social value for the public sector.*

Accordingly, by working together, these parties can draw upon the strengths of one another to pursue a common goal.

Amplify Impact

Foundation staff underscored the appeal of using SIBs to advance progress on their mission. Many interviewees noted that participation in this new market could enhance their

WHILE FOUNDATIONS ARE ENCOURAGED BY THE POTENTIAL OF SIBS TO AMPLIFY THEIR IMPACT, THEY ALSO RECOGNIZE THAT SIBS ARE COMPLEX AND LARGELY UNTESTED, HAVE POTENTIAL ONLY IN CERTAIN SETTINGS, AND ARE HARDLY A PANACEA FOR ALL SOCIAL CHALLENGES.

ability to achieve substantial impact on key areas of interest. By raising investment capital, SIBs deploy a significant new stream of funds that allows service providers to scale up their programs and reach many more individuals. As one interviewee noted, SIBs are feasible only because of recent advances in impact investing; the emergence of a growing community of investors with an interest in applying capital to achieve both financial returns and create social benefit has unlocked access to resources that "increase the pie" for the social sector.

Our conversations suggest that SIBs resonate with foundations differently depending on the nature of the alignment with their mission statements. Broadly, mission alignment falls into three categories:

- ***Program area.*** *SIBs may bring a deep pool of capital to support foundations' program priorities. For example, the Joyce Foundation has deployed grant capital to fund exploration of ways in which SIBs might further its efforts in the area of workforce development, and the W.K. Kellogg Foundation is examining SIBs as a way to enable its grantees to increase their positive impact on vulnerable children.*

- ***Geography.*** *SIBs can tap resources that may be used to benefit geographies of interest. The Dunham Fund made a grant to help bring SIBs to Illinois as part of its commitment to support organizations in its community, and the James Irvine Foundation co-launched an initiative to catalyze the development of pay-for-success agreements in California.*

- ***Financial innovation.*** *Foundations may be interested in SIBs primarily for their potential to apply a new financing approach to the provision of social services. The Edna McConnell Clark Foundation, for example, is helping its grantees explore SIBs as a way to connect to a large and renewable source of funding.*

While foundations are encouraged by the potential of SIBs to amplify their impact, they also recognize that SIBs are complex and largely untested, have potential only in certain settings, and are hardly a panacea for all social challenges.

CASE STUDY

The Rockefeller Foundation: A Leader in SIB Ecosystem Development

Rockefeller Foundation
Innovation for the Next 100 Years

The Rockefeller Foundation has played a strong leadership role in fostering the development of the SIB market. Starting in 2009 when the foundation made a grant to Social Finance UK to explore social innovation financing, it has been drawn to SIBs because of their intersection with impact investing and innovation, two areas of strong programmatic interest. In 2010, the foundation became the only US institution to invest in the Peterborough SIB.

As interest in the concept was escalating in the US, foundation staff believed that they could leverage the knowledge gained through their investment in the Peterborough SIB to contribute to market growth domestically. Kippy Joseph, an associate director of innovation at the Rockefeller Foundation, observed, “With every SIB, the devil is in the details. Having the firsthand experience of being in the [Peterborough] partnership was almost irreplaceable in terms of the insight that would benefit us in thinking about the US market.”

To catalyze the growth of the US market, Rockefeller has deployed nearly $10 million as part of a deliberate strategy that focused on moving SIBs from concept to pilot. In its first grants, it provided operating support to various industry players with the recognition that it would take time before market actors could finance efforts on their own. This support was comprehensive, designed to strengthen various strands of the market simultaneously. Rockefeller’s grants have seeded the field-building activities of intermediaries, government advisors, researchers, and educators, among others. To advance learning, for instance, Rockefeller provided grants to the Nonprofit Finance Fund (NFF) to create a website serving as an information platform on SIBs. It has also funded work by the Center for American Progress to develop educational materials and conduct outreach aimed at sparking a bipartisan dialogue on the topic among federal policymakers.

Over time, the foundation has endeavored to use its support to increase the comfort level with SIBs among commercial investors. Toward that end, it provided Social Finance US with a grant for credit enhancement for a specific SIB transaction. (See sidebar on page 46 for more information.) By sequencing its support in this way, the Rockefeller Foundation aims to help the market become less reliant on philanthropic support over time. Scaling SIBs with new funding sources allows prevention-oriented services to be available to vulnerable communities and prevents more expensive social problems down the line—impact the foundation seeks in its grantmaking strategy.

In addition to monetary support, the foundation has played a key networking and education role in the SIB market. Joseph explained, “As with every network, [the SIB market] really requires a network weaver to make sure that information flows freely and that while every actor is playing his or her own part in the ecosystem, there’s some sense of moving in the right direction all together. Rockefeller in some ways has played that role.” It has supported knowledge-building efforts, for instance, by connecting NFF with the White House Domestic Policy Council to shape a strong agenda for a White House convening on pay-for-success initiatives. It has also facilitated introductions between foundations and organizations working on projects of overlapping interest, and held numerous conference calls to advance learning.

Overall, Joseph characterizes the Rockefeller Foundation’s experience of creating an enabling environment for SIBs as both gratifying and challenging. She is encouraged by the energy and commitment that she sees among the various actors in the market. At the same time, assembling stakeholders from different groups and translating among them can be challenging. Ultimately, Joseph views its cross-sector, systems-level strategy as vital to realizing what the Rockefeller Foundation has identified as the real promise of SIBs: to shift more funding from remediation to prevention, enable government to use taxpayer money for successful services for vulnerable people, and unlock private capital for social benefit.

Founded in 1913, the Rockefeller Foundation’s mission is to promote the well-being of people throughout the world. It has approximately $3.5 billion in assets.

Program-Related Investments: A Primer

Private foundations are required by the IRS to give away at least 5 percent of their endowments annually, and typically invest the other 95 percent in debt, equity, and other financial instruments to maximize returns that enhance the size of their endowment. Program-related investments (PRIs) offer the opportunity for foundations to deploy their funds in a different way: as investors in socially beneficial projects.

PRIs are one form of mission investing, which refers to all investments by charitable foundations that generate both a social and financial return. Mission investments have the advantage of magnifying the impact of philanthropic dollars by providing an opportunity to earn repayment of principal plus a financial return. Thus funds can be recycled, and used to seed multiple initiatives over time.

The mission investing umbrella includes two types of tools: mission-related investments (MRIs) and PRIs. MRIs are funded from investment assets alone; they must meet the applicable prudent investor standards, and are expected to earn a market-rate financial return plus achieve social impact in line with the mission of the foundation. By contrast, PRIs are investments that may be funded from either program or investment dollars to achieve specific program objectives and are expected to return capital, often with modest returns. The IRS regulates the use of PRIs among private foundations. Although they are not subject to the same regulations, community foundations that make mission investments tend to think of them in similar categories.

Since the Ford Foundation pioneered the use of PRIs in 1968,[8] the PRI market has made considerable strides but remains limited in size and scope. In 2009, foundations made over $700 million in PRIs, compared to less than half as much a decade earlier. However, this is miniscule compared to the $40 billion in grants that foundations deployed in 2009.[9] For the past two decades, only about 1 percent of US foundations made PRIs each year.[10]

The decision of whether or not to engage in PRIs is individual to each foundation, depending mostly on its appetite for risk and innovation as well as its staff capacity and board approval. The relatively low level of PRI activity is due in part to the limited number of viable investment opportunities, high transaction costs, and thin market infrastructure. Moreover, a PRI program requires a skill set that blends mastery of financial analysis with social impact awareness and assessment—a highly unusual combination in most foundations, where program and investment staff tend to operate separately from one another.

Figure 4. **Growth in program-related investments in the United States**

Source: Lilly Family School of Philanthropy, Indiana University, "Leveraging the Power of Foundations: An Analysis of Program-Related Investing" (May 2013). PRI data comes from the IRS Statistics of Income (SOI) dataset.

8 The Ford Foundation, "Program-Related Investment," available at http://www.fordfoundation.org/grants/program-related-investment.

9 Foundation Center, "Foundation Growth and Giving Estimates: Current Outlook" (2010), available at http://foundationcenter.org/gainknowledge/research/pdf/fgge10.pdf.

10 These figures reflect the most recent data available. Source: Lilly Family School of Philanthropy, Indiana University, "Leveraging the Power of Foundations: An Analysis of Program-Related Investing" (May 2013), available at http://www.philanthropy.iupui.edu/files/research/complete_report_final_51713.pdf.

Deploy PRI Capital

By facilitating investments aimed at reducing homelessness, lowering prison recidivism rates, and addressing other persistent social challenges, SIBs provide another avenue for foundations to make program-related investments (PRIs). To date, most PRIs have directed foundation capital to bricks-and-mortar projects such as affordable housing and community facilities. (For a primer on PRIs, see the sidebar on page 22.) SIBs offer an opportunity for foundations to diversify their PRI portfolios by facilitating direct investment in human capital.[11] In this way, SIBs expand the available options in the PRI universe. Over time, SIBs may also become viable candidates for mission-related investments (MRIs), market-rate investments made out of foundation endowments.

The sense that foundations can assume risk that others cannot[12] was widespread in our small sample—as was enthusiasm for exploring new, innovative forms of financing for the social sector. The first SIB deals will be opportunities to learn, one respondent observed. Some project components will work while others will require adjustment. But foundations can absorb some of the burden of failure, from which market participants can learn a great deal. Another program officer added, "I don't see the SIB market developing without foundations. Any innovation is inherently unproven at its inception, and that's where we are now."

ONE PROGRAM OFFICER EXPLAINED HER INTEREST IN SIB PILOTS BY COMMENTING, "WE HAVE THE CHARGE TO UNDERWRITE INNOVATION, TO TEST NEW MODELS IN WAYS THAT ARE MUCH HARDER FOR OTHER ACTORS LIKE GOVERNMENT TO DO."

HOW TO ENGAGE

All of our interviewees considered foundation engagement with the SIB market to be valuable, regardless of whether their organization was playing an active role. Many expressed the belief that foundations should take risks to test innovations like SIBs. One program officer explained her interest in SIB pilots by commenting, "We have the charge to underwrite innovation, to test new models in ways that are much harder for other actors like government to do."

Indeed, this would reflect the traditional role of philanthropy as a research-and-development entity that works to prove a concept before it can be scaled by government. While this relationship was strong in the past, in recent decades it has been lacking. Restoring this dynamic would enable foundations to seed the SIB market with an eye to handing it off to other stakeholders, like government, over time.

11 *Economists generally consider expenditures on housing, training, and health care as investments in human capital, which are aimed at raising earnings, enhancing health, and improving lifestyle choices.*

12 *At the same time, the fact that foundations have the ability to take on risks does not mean that they necessarily are willing to do so. In particular, some foundations feel that they should not be the only participant to take on risk in SIB transactions.*

Foundations that find SIBs appealing and worthy of exploration have a menu of options from which to choose. Broadly, foundations can support SIBs in four ways: through grantmaking, investments, partnerships, and advocacy.

Grantmaking

Foundations can deploy grants to facilitate the ultimate development of a robust SIB market. Foundations can guide the market's evolution by providing grants to build capacity among key participants, conduct research and encourage learning, develop a proof of concept, pay for outcomes, and mitigate risk.

Build Capacity among Key Participants

- **Service providers.** Many service providers across the country oversee innovative programs that convey lasting benefits to individuals in need. However, relatively few organizations have had the opportunity to document their impact, which in turn limits their ability to attract investment. Foundations can support capacity building within service providers to improve their data collection practices and fund program evaluations in an effort to build their evidence base. Analysis of program costs versus benefits would also be helpful in clarifying the value that the services convey. Foundations that help organizations clearly demonstrate their performance can create a robust pipeline of growth-ready nonprofits—in turn, paving the way for these organizations to participate in social innovation financing transactions such as SIBs. This type of support aligns with broader efforts to foster a more data-driven social sector.

- **Intermediaries.** SIB market intermediaries play an integral role in developing, launching, and managing SIBs as well as conducting research and education to help build the market. They add value by engaging in any or all of the following activities:

  - *Research and test potential applications for SIBs,*
  - *Coordinate and align the interests of stakeholders,*
  - *Structure investments,*
  - *Support the capital-raising phase of the project, and*
  - *Provide technical assistance to service providers.*

  Intermediaries can be particularly helpful in bridging the cultural divide between investors and government, as well as in ensuring that the interests of the populations being served are protected. Over time, intermediaries—many of which are nonprofits themselves—may earn fees on SIB deals that are sufficient to cover the costs of their operations. In the meantime, foundations can support these firms as they contribute to the development of the SIB market·

FOUNDATIONS THAT HELP ORGANIZATIONS CLEARLY DEMONSTRATE THEIR PERFORMANCE CAN CREATE A ROBUST PIPELINE OF GROWTH-READY NONPROFITS—IN TURN, PAVING THE WAY FOR THESE ORGANIZATIONS TO PARTICIPATE IN SIBS.

CASE STUDY

The Pershing Square Foundation and Omidyar Network: Building Capacity within the SIB Market

The Pershing Square Foundation and Omidyar Network were two of the first foundations to support the development of the US SIB market. Additionally, Omidyar Network has supported Social Finance UK to explore the use of SIBs in an international context. Both organizations were drawn to the potential of SIBs to open up a new source of capital to fund social change. Paul Bernstein, CEO of The Pershing Square Foundation, noted that his foundation was particularly interested in the opportunity to deploy market forces to drive progress in the social sector. Amy Klement, a partner at Omidyar Network, agreed and added that SIBs have the potential to change the way that government functions. She also highlighted the tool's need for a solid evidence base, which she said the philanthropic sector can encourage and support. "Foundations can play a role in identifying the areas of potential for SIBs," she explained, "and then funding a grant to do a pilot program collecting the base case data."

Both foundations have made grants to support the growth of the US SIB market, including providing operating capital to intermediaries and other players working to develop the space. As Bernstein commented, The Pershing Square Foundation's interest is in building capacity among organizations that are, in turn, building the market. For its part, Omidyar Network supports a "sector-based" approach—encouraging systemic evaluation that encompasses an entire industry or sector and not just an individual firm or idea. Accordingly, both foundations made founding grants to Social Finance US, a SIB intermediary organization. In addition, Omidyar Network also made a grant to McKinsey & Company to fund research on the SIB market.

Both foundations have also contributed human capital—their expertise, connections, and deep knowledge—to support the development of the market. Bernstein and Klement are observers on the board of Social Finance US, and their foundations contribute technical assistance as needed. The Pershing Square Foundation and Omidyar Network have been active in helping Social Finance build its board, and Omidyar Network assists the organization with its human capital development. This work underlines the fact that foundations bring more than money to the SIB market; they also bring a vast pool of knowledge and non-financial resources that are equally valuable in moving the market forward.

The Pershing Square Foundation, based in New York, was founded in December 2006 by Karen and Bill Ackman. Bill is the CEO and Portfolio Manager of Pershing Square Capital Management, L.P. The Pershing Square Foundation has committed $225 million in grants and social investments to support exceptional leaders and innovative organizations that tackle important social issues and deliver scalable and sustainable impact.

Established in 2004 by eBay founder Pierre Omidyar and his wife Pam, Omidyar Network is a philanthropic investment firm dedicated to harnessing the power of markets to create opportunity for people to improve their lives. It has more than $275 million in assets.

CASE STUDY

Laura and John Arnold Foundation: Supporting Social Innovation Financing to Enhance Public Accountability

In recent years, cities and states across the US have struggled to balance their budgets. They have been forced to cut services, eliminate positions, and implement hiring and wage freezes. Treasurers and comptrollers have been asked to scrutinize every penny, and elected officials have had to decide which programs to keep. While the current fiscal environment has presented a number of challenges, it has also provided an opportunity to reorient government spending around outcomes and innovation. Policymakers now have a new tool, social innovation financing (SIF), which can be used to improve services to address social issues.

Laura and John Arnold Foundation (LJAF) believes SIF can help reallocate limited resources toward proven interventions that help those with the greatest needs. The private foundation, with offices in Houston and New York City, is known for its use of data and analytics to help solve some of society's most urgent and persistent problems—an approach The Wall Street Journal termed "the new science of giving." As part of LJAF's focus on public accountability, it has invested $8.4 million in SIF projects. "We identify challenges and address their root causes through innovative, multi-disciplinary solutions," LJAF vice president of public accountability Josh McGee explained. "SIF is exactly that type of tool. It has the potential to change the way government operates and provides services to those who need them the most. Private investors cover the cost of a program upfront, and the government only pays if the program is actually shown to make a difference."

LJAF provides support for the Harvard Kennedy School's Social Impact Bond (SIB) Technical Assistance Lab, the Social Impact Partnership in New York State (see page 46 for a detailed description of the project), and the Massachusetts Juvenile Justice Pay for Success Initiative. The projects in New York and Massachusetts will provide services to individuals at risk of returning to prison, and any returns on LJAF's investment will be used to support future SIF projects with the goal of rigorously evaluating programs and scaling those that are proven to have an impact. LJAF's commitment to SIF is an extension of the foundation's work in evidence-based policy-making. In 2013, the foundation committed $29.8 million to organizations that are working to encourage and facilitate government decision-making based on rigorous research and evaluation.

"By focusing on evidence and studying 'what works,' governments can ensure that taxpayer dollars are allocated in the smartest, most efficient way," McGee explained. "SIF, and its emphasis on prevention, can help transform the way government works. The tool promotes a shift from stagnant and underperforming policies toward proven and efficient programs—a practice that, regardless of the economic climate, is always fiscally sound."

Founded in 2008, the Laura and John Arnold Foundation's core objective is to produce substantial, widespread, and lasting reforms that will maximize opportunities and minimize injustice in our society.

- **Government.** Government agencies engaging in SIB development can benefit from external support in designing and implementing this unique type of public-private partnership. To support government's engagement with the model, the Rockefeller Foundation provided a grant funding the creation of the Harvard Kennedy School SIB Technical Assistance Lab, which provides pro bono technical assistance to localities that are preparing to launch SIB projects. The SIB Lab has supported SIB development work in New York State and Massachusetts, among other geographies. In early 2013, it launched a nationwide competition for other localities interested in gaining its assistance with SIB development. The SIB Lab received 28 applications, indicating widespread interest in SIBs within the public sector, as well as the desire to benefit from external expertise. It selected and is actively working with 10 governments. In addition to the Rockefeller Foundation, the Dunham Fund and the Laura and John Arnold Foundation are supporting the SIB Lab's efforts.

THE ROCKEFELLER FOUNDATION PROVIDED A GRANT FUNDING THE CREATION OF THE HARVARD KENNEDY SCHOOL SIB TECHNICAL ASSISTANCE LAB, WHICH PROVIDES PRO BONO TECHNICAL ASSISTANCE TO LOCALITIES THAT ARE PREPARING TO LAUNCH SIB PROJECTS.

Conduct Research and Encourage Learning

- **Market research.** Foundations may foster learning by funding research on the SIB market. A number of foundations, including the F.B. Heron Foundation, Omidyar Network, the Robert Wood Johnson Foundation, Rockefeller Foundation, William and Flora Hewlett Foundation, and W.K. Kellogg Foundation, supported McKinsey's 2012 report on SIBs, which outlined the US market's potential.[13] Other studies of the market could explore how pay-for-success strategies may accelerate scale in the social sector or how they can be best integrated with existing public funding streams. Lessons learned from early-stage SIB projects could also be catalogued.

- **Feasibility studies**. Not all social programs are suitable for SIB financing. Foundations can fund feasibility studies to identify a fit between the social need and the tool. Intermediaries are well positioned to carry out this analysis, which could include an assessment of the social problem, examination of evidence-based interventions, identification of growth-ready service providers, and modeling of a potential transaction's economics. Foundations may choose to support feasibility studies as a way to examine whether SIBs can help them magnify their impact within a given program area or for a target geography.

- **Information hubs.** Given the relative youth of the SIB market, a central source of neutral information about SIBs is valuable. Toward that end, the Rockefeller Foundation,

13 McKinsey & Company, "From Potential to Action: Bringing Social Impact Bonds to the US" (2012), available at http://mckinseyonsociety.com/downloads/reports/Social-Innovation/McKinsey_Social_Impact_Bonds_Report.pdf.

the William and Flora Hewlett Foundation, and the Joyce Foundation funded the Nonprofit Finance Fund (NFF) to serve as an information source on the pay-for-success model. NFF hosts a website that aggregates resources on the topic and provides assistance to service providers, government, and other stakeholders exploring this type of financing. Other foundations may consider funding complementary initiatives, such as an affinity group that connects stakeholders with an interest in this space.

Develop a Proof of Concept

- **Support demonstration projects.** With the SIB market still relatively new and untested, it is important that stakeholders maximize projects' probability of success by selecting interventions with a strong record of improving individuals' lives. Toward building a pipeline of SIB-ready interventions, a foundation may fund a demonstration project to identify scalable models for SIBs and create an evidence base from which a SIB could be designed. The California Endowment provided such a grant to Social Finance US and Collective Health for a demonstration project to fund asthma management services in Fresno, California. (See page 29 for more information on The California Endowment's support of a SIB demonstration project.) Demonstration projects may be a valuable way to improve the evidence base for interventions to support the launch of a SIB in a specific geography and facilitate its replication elsewhere.

- **Subsidize early-stage projects.** Early-stage projects can carry relatively high transaction costs, as well-established templates do not yet exist and risks are not yet well understood. To help overcome this obstacle, foundations can support SIB market development by bearing some of the costs of early-stage projects. For instance, a foundation can fund the evaluation or intermediary cost of a particular SIB deal. To support the New York City SIB transaction, Bloomberg Philanthropies made grants to MDRC, which is serving as the program intermediary, and the Vera Institute of Justice, which is providing evaluation services. One interviewee observed that support of intermediaries is especially useful in early-stage deals, since these projects may not be large enough to cover fixed costs.

WITH THE SIB MARKET STILL RELATIVELY NEW AND UNTESTED, IT IS IMPORTANT THAT STAKEHOLDERS MAXIMIZE PROJECTS' PROBABILITY OF SUCCESS BY SELECTING INTERVENTIONS WITH A STRONG RECORD OF IMPROVING INDIVIDUALS' LIVES.

Pay for Outcomes

Another way to address the high cost of early transactions is for a foundation to take on all or part of the cost of paying investors if outcomes are achieved in specific SIB transactions. While governments are currently playing the role of "payor," foundations can consider contributing to investor payments or substituting for governments in this role. By supplementing

CASE STUDY

The California Endowment: Demonstrating the Value of Upfront Funding in Chronic Health Management Programs

In March 2013, The California Endowment (TCE) made a grant of $660,000 to support Social Finance US and Collective Health in launching the first phase of a demonstration project in Fresno, California. Fresno has a particularly high incidence of asthma with about 20 percent of children suffering from the chronic disease. In line with its mission to improve health outcomes in California, TCE made this grant to fund asthma home care and education for the families of 200 low-income children suffering from asthma. These proven asthma management strategies, which focus on reducing environmental triggers, are typically not funded by health insurers despite numerous studies that demonstrate their effectiveness in improving health outcomes for asthma sufferers. Without proper management, asthma can lead to unnecessary and expensive emergency room visits and hospitalizations, and can impede learning through missed days of school.

Through this project, Social Finance and Collective Health aim to demonstrate the social and economic benefits of investment in upfront asthma management services. Insurance claims data collected over the course of the project will document the cost savings due to program participants' reduced need for emergency care. The data will serve as evidence to support the case for scaling the program to reach many more children in need. In addition to overseeing the provision of asthma management services, the partners will convene an advisory group, which will work to design a SIB to scale up the program after the demonstration project is complete.

Anne Stuhldreher, a senior program manager for strategic initiatives at TCE, noted that support for this project involved substantial dialogue within the foundation. TCE program staff weighed where it could best lend value to emerging innovations in social financing. Ultimately, TCE decided to start with a small demonstration project that Collective Health and Social Finance proposed. By focusing on one locale and a programmatic area where TCE and its partners have a high level of expertise and experience, everyone involved hopes to eventually achieve scale through a social investing strategy. "If this leads to the first SIB in California, we want to lay the groundwork for it to be successful. The project wasn't ready for a SIB 6 months ago, but we hope it will be after 18 months of operations. An approach that went slower made sense for us," Stuhldreher explained.

Established in 1996, The California Endowment is a private foundation committed to expanding access to quality health care for the underserved statewide, and improving the health of all Californians. It has approximately $3.7 billion in assets.

	GRANTMAKING	INVESTMENTS	PARTNERSHIPS	ADVOCACY
Capacity building among key participants	✓			
Research and learning	✓		✓	✓
Demonstration projects and pilots	✓	✓	✓	✓
Payment to SIB investors	✓			
Risk mitigation	✓	✓	✓	✓

Figure 5. **How foundations can add value to the Social Impact Bond market**

outcomes payments made by government, foundations can facilitate scaling up of pilot projects. Foundations that pay for SIB outcomes can help bring more SIBs to market and ultimately support the creation of a track record that will be useful in attracting commercial capital to future SIB-financed projects.

Although this paper examines the US market, the UK Big Lottery Fund (BIG) provides an interesting example of how a foundation can help support the payment of outcomes. BIG committed funds for outcomes payments related to the Peterborough SIB as part of its effort to stimulate government demand for the tool and champion innovation. This commitment supplements the UK Ministry of Justice's agreement to pay for outcomes on the same transaction. While it is technically a public body, BIG operates similarly to a foundation, distributing grants of approximately £750 million per year for charitable purposes.

Foundations could pay for outcomes where governments are reluctant to participate. For instance, they could pay to expand programs that produce valuable outcomes but do not deliver net benefits within an investor-friendly timeline. Early childhood programs, among other interventions, may be good candidates for this approach because many of the benefits occur further down the line.

Mitigate Risk

Another role foundations can play is to encourage investors to direct capital into the SIB market by mitigating risk through credit enhancement of transactions. Credit enhancement decreases the financial risk of specific SIB transactions for mainstream impact investors, thus lowering the cost of capital. Credit enhancement can take the form of a financial guarantee of mainstream impact investors' capital, or a subordinated position in a transaction. In addition to grants and recoverable grants, PRIs can also be used to provide credit enhancement. The first US SIB involved credit enhancement in the form of Bloomberg Philanthropies' partial guarantee of Goldman Sachs' capital. (See page 34 for more information on Bloomberg Philanthropies' involvement with the New York City SIB.) In a SIB financing early childhood education in Utah, philanthropist J.B. Pritzker is providing a subordinated loan of up to $2.4 million to reduce the financial risk of Goldman Sachs, which is investing up to $4.6 million.

Given the lack of long-term data and experience at this early stage in market development, such credit enhancement may be desirable in some SIB transactions to help attract commercial capital. Bringing private investors into these early projects lays the groundwork for SIBs' eventual self-sustainability.

Investment

Using PRIs, foundations can become investors in the SIB market. Laura and John Arnold Foundation, for instance, made a philanthropic investment through a PRI in the New York State SIB transaction. (See page 26 for more information on the Laura and John Arnold Foundation's participation in the SIB market.) PRIs can fund entire SIB pilots, or they can be combined with commercial capital or grant money to finance transactions. When combined with investment by mainstream impact investors, foundations making PRIs can help absorb some of the costs of early transactions by accepting a lower rate of return. By investing in early-stage deals, foundations can help create proof points in the market, paving the way for commercially oriented capital to enter the space over time.

As the market matures, SIBs may be viable candidates for MRIs. They may pass the test of fiduciaries overseeing institutional assets, including foundations making MRIs, enabling access to a deep pool of capital that can be drawn upon to finance larger efforts. For the moment, staff at most of the foundations that we interviewed believe that PRIs are the appropriate vehicle for foundations wishing to invest in the SIB market.

Partnerships

Foundations can also support the development of the SIB market by fostering partnerships among stakeholders. Philanthropic organizations' deep knowledge of various stakeholders in the field—service providers, government, and intermediaries—positions them to gather the right actors to the table and facilitate meaningful conversations. Foundations can leverage this knowledge to help build constituencies that support the expansion of preventative services and evidence-based programs. They can also build on their role as conveners in various communities—both geographic and programmatic—to explore PFS partnerships with government, investors, and service providers. One interviewee noted that community foundations have a special ability to convene groups based on their deep knowledge of local issues and stakeholders.

A foundation that has worked to advance SIB partnerships among multiple sectors is the the J.B. and M.K. Pritzker Family Foundation. In March 2014, the foundation is sponsoring a convening to help stakeholders understand and develop pay-for-success contracts funding early childhood programs. The conference brings together leaders from government, finance, and the social sector, among other fields, to explore issues such as data needs, evidence, potential financing structures, and policy and legislative concerns.

Advocacy

Finally, foundations can play a role in advancing the SIB market by helping to educate key stakeholders, especially lawmakers and government officials. SIB education includes not only an explanation of how the tool works, but also the reasons for engaging with this new tool, what a developed market might look like, and why good data matters. This educational work can indirectly influence policy, attitudes, and legislation. Enabling legislation is particularly critical in paving the way for SIBs as it may provide assurance to investors that governments will follow through on their promise to pay for results. The Rockefeller Foundation funded the Center for American Progress to create educational materials and conduct outreach to advance the learning of federal policymakers around the pay-for-success concept. (See page 21 on the Rockefeller Foundation's support of the SIB ecosystem.) Some of our interviewees observed that large, national foundations may have a "comparative advantage" in broad-based research and education programs designed to improve public awareness and support of SIBs. In addition, community foundations may have greater flexibility to undertake advocacy efforts because they are not bound by the restrictions around lobbying that may constrain similar efforts by private foundations.[14] many foundations are not accustomed to "seeing the world through an investment lens." Thus many foundations may prefer to continue engagement via direct grants to service providers.

ONE FOUNDATION EXECUTIVE ASKED, "ARE SIBS PART OF A LARGER CONVERSATION ABOUT WHAT IT WILL TAKE TO SUSTAIN A SOCIAL SAFETY NET GOING FORWARD?"

OBSTACLES & CONCERNS RELATED TO ENGAGEMENT

Foundations may encounter challenges at each phase of participation in the SIB market. Deciding whether to enter the market, navigating the space, and defining a long-term approach all present obstacles for foundation staff, who must engage in thoughtful dialogue and reflection in order to advance a SIB strategy. Our interviewees noted some of the challenges that may surface in each of these stages.

Weighing Options: Deciding Whether to Engage

Challenge Tradition

SIBs represent a new way to channel resources to the social sector. Foundations, on the other hand, have a long and venerable history—and some of our interviewees commented that such institutions do not change course lightly. By emphasizing investment and performance-based payment, SIBs disrupt the status quo method of financing social services.

Given that grant monies are a valuable and scarce resource, it is hardly surprising that some foundations would hesitate before entering this new and unproven market. Making PRIs in SIBs may be an especially big leap. As one interviewee observed,

Cut through the Hype

Furthermore, some interviewees expressed concern over the "hype." They noted that the media has devoted a great deal of attention to the emerging SIB market in the US, which stands in sharp contrast to the modest number of transactions on the ground. Moreover, a lack of proof points creates a situation in which some onlookers are questioning whether the tool can realize the anticipated benefits. One foundation executive voiced concern that some are rushing into the SIB market without enough data. While he supports investigating the SIB concept, he believes that only a few projects should be fully tested before further activity follows. Another interviewee cautioned against overselling the potential benefits of SIBs. She added that while the use of SIBs to scale proven programs would certainly be beneficial, it may only make a peripheral difference within the social sector, where so many variables affect individuals' lives. Indeed, issues surrounding poverty are multi-dimensional and complex. For example, while SIBs may be aimed at prevention of asthma-related hospital visits, they may not address the deep social ills that result in high rates of asthma among low-income children. And several

14 For further discussion of permissible advocacy activity for foundations, see Council on Foundations, "A Foundation's Guide to Advocacy" (2010), available at http://cof.org/files/Bamboo/programsandservices/publicpolicy/documents/A_Foundations_Guide_to_Advocacy.pdf.

interviewees noted that while SIBs may have the potential to improve some lives, they cannot effect fundamental change in the social infrastructure.

Avoid a Substitution Effect

Some interviewees also cited a concern that if SIBs are funded by grant money that would have gone to service providers anyway, this is merely a substitution—it does not contribute to "growing the pie" of resources for the social sector. To the extent that SIBs eventually attract large amounts of commercial capital, this concern would fade away. (The SIB transaction launched in New York State, described on page 46, provides an early indication of strong interest from mainstream impact investors.)

Along similar lines, some market observers cite worry that enthusiasm for SIBs will drain resources away from foundations' grant budgets and lead them down a slippery slope toward skewed priorities. A proliferation of SIBs may shift resources away from social service programs that are not good candidates for the tool, especially those with a long timeline to success or those with substantial unquantifiable benefits. Since only very specific and relatively few social programs are good candidates for SIBs at this early stage, some foundation staff may be concerned that money will be drawn to those problems and away from complex, long-term challenges.

Some interviewees also voiced concern about another form of substitution effect: SIBs taking attention away from larger, systemic reforms. One foundation executive asked, "Are [SIBs] part of a larger conversation about what it will take to sustain a social safety net going forward?" In his view, SIBs are Band-Aids that could deflect nonprofits and foundations away from broad-based work aimed at grappling with bedrock issues, such as scarcity and donor fatigue.

Overcome Knowledge Gaps

As one of our interviewees noted, there is a great deal of public and media interest in SIBs—but we still need to build deep understanding of this new tool. While many foundation staff whom we interviewed are quite familiar with the concept of social innovation financing, including SIBs, media coverage is not always accurate. For example, the term is often used interchangeably with pay-for-success, yet they have different meanings. (See sidebar on page 11 defining the difference between SIB and PFS.) SIBs are sufficiently complex instruments as to involve a learning curve; one program officer suggested that the threshold of basic understanding required for SIBs is higher compared to other endeavors.

The flexibility of SIBs adds to the confusion, as two SIBs can share a certain set of characteristics but look very different from one another. Moreover, misperceptions are common. One of our interviewees pointed to the misperception that SIBs "let government off the hook." He stressed the importance of conveying that SIBs do not replace government, but rather introduce innovation in the way that government funds social services. Indeed, government is a key partner in the development of SIBs and integral in providing the data underlying a deal's economics.

Foundations entering the SIB market must undergo a learning process that goes beyond a basic understanding of the tool. One foundation director said that before his foundation entered the market, he and his colleagues asked a lot of questions and discussed their concerns internally. They considered the value of an intermediary against its cost, as well as what criteria indicate when SIBs may be appropriate. Another interviewee mentioned the need for learning across the foundation in order to approve a grant for a SIB-related project.

Several others expressed a specific concern about the current terminology, arguing that the term "bond" is distracting at best and misleading at worst, especially in conversations with potential investors. One program officer described this as "releasing an apple into the world and calling it an orange." Another interviewee acknowledged that while "SIBs" may be a misnomer, the term has gained a certain currency at this point. He suggested that focus should shift away from discussion of terminology and toward a more comprehensive market education initiative.

CASE STUDY

Bloomberg Philanthropies: Bringing Commercial Investors to the Table

Bloomberg Philanthropies

When New York City became the first locality in the US to launch a SIB, the risk was too high and the landscape too unknown for commercial investors to become involved without some form of credit enhancement. Bloomberg Philanthropies stepped up, agreeing to guarantee 75 percent of the investor's capital through a $7.2 million grant to MDRC, a social services provider and intermediary that has designed and will oversee the program. The guarantee is structured as an evergreen facility so that if the funds are not utilized in the New York City transaction, MDRC can use them for future SIB deals. Goldman Sachs is the investor in the $9.6 million project, which aims to reduce recidivism among young men exiting the Rikers Island corrections facility. In addition, Bloomberg Philanthropies provided funding for the evaluation and intermediary costs of the transaction through grants to the Vera Institute of Justice and MDRC, respectively.

What attracted Bloomberg Philanthropies to this project? James Anderson, who leads the government innovation portfolio at the foundation, explains that two key factors motivated their participation. First, foundation staff identified the SIB model as one that could be of interest to local governments, which have come under significant and persistent budgetary pressure and are searching for ways to engage the private sector in solving public problems. SIBs align with the foundation's focus on spreading proven and promising ideas among cities. Second, the foundation was interested in using philanthropy to bring in greater support for New York City Mayor Michael R. Bloomberg's Young Men's Initiative, which was launched in 2011 to tackle the broad disparities slowing the advancement of young black and Latino men in the city. By providing a guarantee, the foundation was able to leverage $9.6 million in private dollars from Goldman Sachs, significantly expanding the pool of resources available.

Bloomberg Philanthropies and its partners in this project were well aware of the responsibility of creating the first US SIB, and that they would be setting a "standard that should live up to the promise" of the tool, in Anderson's words. Not surprisingly, the process was long and iterative, but they were determined to get this right and to blaze a path that others could follow. Now that the project is underway, Bloomberg Philanthropies is committed to learning from this SIB, and to sharing this learning with others in the field.

Anderson believes that momentum around SIBs is growing in the US, and he is optimistic about the future course of this market. Now that there are templates and models to follow, he expects that the process should become easier and transaction costs should fall. Providing the guarantee as well as funding intermediation and evaluation costs were critical to attracting private-sector capital to this first deal, he explains, but should become less important as SIBs develop a track record.

Bloomberg Philanthropies focuses on the environment, education, government innovation, and the arts. It distributed approximately $370 million in 2012.

We're In: Crafting & Implementing an Engagement Strategy

Develop a SIB Strategy

Some foundations find the SIB concept appealing, but struggle with issues around how best to support the market and when to get involved. There is significant demand for more resources within the social sector across a variety of issue areas and geographies. Where to target efforts can be challenging for foundation staff surveying the field. Although they want to participate in the SIB market, some foundations are waiting for proof points or a given level of momentum before they commit funds to the space.

Engineer Effective Implementation

The newness of SIBs also creates challenges related to participation in the early stages of a market. Several of our interviewees cited concern with the slow progress and unexpected complexity encountered in developing early SIB transactions in the US market. One staff member at a foundation that has supported an early-stage project commented that the process had not been easy, and that the final project was very different from the initial concept. Another interviewee admitted that they are "struggling" with the challenges of getting projects up and running in a timely fashion—but was quick to add that her concerns are with the abovementioned process issues, not the SIB concept itself.

SEVERAL OF OUR INTERVIEWEES CITED CONCERN WITH THE SLOW PROGRESS AND UNEXPECTED COMPLEXITY ENCOUNTERED IN DEVELOPING EARLY SIB TRANSACTIONS IN THE US MARKET.

Once a foundation has decided to enter the SIB market, staff must decide how to engage: whether to make grants or investments in the market, or support the market through advocacy, partnership development, or policy research and education. With regard to directing capital toward specific transactions, one interviewee stated that SIBs "sit uneasily between grants and investments." Another program officer questioned whether deploying grants would undermine the logic of SIBs, which are intended to produce financial as well as social returns. On the other hand, several foundations observed that SIBs may be too risky at present to qualify for some foundations' PRI portfolios—meaning that grants would be the only option. In the early stages of market development, the lack of a long-term track record for SIBs and poor understanding of risk are barriers to participation through PRIs for some foundations.

To a large extent, the challenge of building a new ecosystem from the ground up is part and parcel of the innovation process. One foundation cited a lack of templates that can be used for pilots, but suggested that as market participants gain experience through on-the-ground SIB projects, the process will become much less complicated. There is also an extra cost associated with being an early player in a new market. Foundations working on these deals emphasized the "importance of getting it right" to create examples that inspire replication.

Related to this point, however, another foundation staff member noted with concern the issue of transparency with regard to progress and outcomes of early SIB deals. Transparency is needed to accelerate the development of the

SIB market so that participants can learn from the successes (and failures) of others. There is no guarantee of transparency at present, however, partly because of privacy concerns as well as some reluctance to share learnings with potential competitors.

Make Collaboration Work across Sectors

The challenge of the collaborative, comprehensive approach is that different stakeholders' interests must be aligned at the start of the project—and remain aligned through the life of the project. As one interviewee pointed out, keeping a diverse group of partners together requires extra effort in "translation." Sometimes the foundation has to use a "different language" in working with communities, such as investors and government, that do not often collaborate.

In this context, a few interviewees expressed a specific concern about the risk of relying on government over a number of years. One underlined the risk that politics might interfere with project execution over time. He added that many of his organization's investors embrace private initiatives to tackle social challenges because of their frustration with the public sector. The passage of enabling legislation for a SIB can mitigate some of the concerns around political risk.

Avoid Unintended Consequences

Some market observers cite a worry that reliance on rigorous outcome targets will create perverse incentives and other unintended consequences. This concern highlights the importance of optimizing the design of the SIB project to avoid sending the wrong signals. A poorly designed program, for example, could incentivize participants to cherry-pick only those participants who are most likely to succeed. Other metrics can lead to poor outcomes for beneficiaries. A reduction in foster care placements, for instance, may lead to keeping children with their families even when they may be better served through other arrangements. (These problems can be avoided through the use of complementary metrics, as well as frequency rather than binary metrics.[15]) Additionally, the fact that payments to SIB investors are based on measurable outcomes raises the concern that a poorly designed SIB project could set up the wrong incentive by measuring only that which is easy to quantify.[16]

The burden that SIBs may place on participating nonprofits and the consequences of failed deals were also topics evoking uncertainty. One foundation executive had reservations about how SIBs might affect the day-to-day operations of service providers. He believed that these projects might place undue strain on the staff at participating organizations. Another executive questioned whether subjecting service providers to higher levels of scrutiny would come at a cost. For example, he wondered whether an organization with a weaker evidence base would replace a service provider that failed to achieve target outcomes.

Overcome Data Challenges

Several of our interviewees mentioned concerns about the quality of data in the social sector, especially for outcomes measurement. In transactions where payments hinge on the evaluation of program outcomes, the quality and quantity of data, they stressed, must be unimpeachable. One interviewee commented that in many cases, service providers and governments lack standardized, high quality data around the effects of service delivery, hampering their ability to participate in SIB-financed programs.[17]

As alluded to above, other market observers are unsure about the effect of measuring and quantifying only the social benefits that are more easily monetized. SIBs' emphasis on rigorous data measurement and evaluation is laudatory, but problematic at the same time. Much of the emphasis on metrics is based on hard costs, which have

15 *For further discussion of this concept, see Social Finance Ltd, "Youth Outcomes: A Guide for Service Providers and Commissioners" (October 2012), available at http://www.socialfinance.org.uk/resources/social-finance/payment-results-youth-sector.*

16 *This is "metric drift" or "metric bias" as described by Georgia Levenson Keohane in Social Entrepreneurship for the 21st Century: Innovation Across the Nonprofit, Private, and Public Sectors (New York: McGraw-Hill, 2012).*

17 *These concerns are largely addressed in a well-designed SIB. As part of the project development phase, partners pre-determine exactly what data will be required, as well as how to monitor and measure the data. This enables service providers and government to enhance their systems in advance, if needed, to ensure data integrity.*

the advantage of being objective and verifiable. But the costs of social ills—and the benefits of overcoming them—may not be wholly quantifiable. There will always be inherent limits to our ability to holistically measure costs and benefits attached to social issues. This may, in turn, raise questions about the ability of the SIB model to wholly capture the benefits associated with SIB-based projects.

Cope with Silos in the Public Sector

The issue of silos as an obstacle to SIB market development emerged as a recurring theme throughout our research. There are two kinds of silos in the public sector:

- *Vertical silos between different levels of government (local, state, national), which distribute costs and benefits unevenly; and*
- *Horizontal silos between government agencies (e.g., health, housing, corrections), which tend to fragment responses to issues that cut across all silos.*

SOCIAL PROBLEMS ARE NOT SILOED BUT MULTIFACETED, SPANNING SECTORS AND LEVELS OF GOVERNMENT ALIKE. THIS MEANS THAT RESPONSES TO THESE PROBLEMS MUST BE EQUALLY MULTIFACETED.

The problem, of course, is that social problems are not siloed but multifaceted, spanning sectors and levels of government alike. This means that responses to these problems must be equally multifaceted—but traditional divisions within government do not support this hybrid approach.

Cope with Silos in Foundations

The philanthropic sector is also somewhat siloed, marked by divisions between program and investment staff that may obstruct progress in developing the SIB market. In particular, these silos complicate the process of funding SIBs through PRIs. Many of our interviewees cited a lack of human capital capacity as an important constraint when it comes to investing in SIBs. Only a small number of foundations make PRIs, and even fewer link their investment and grantmaking staff in any meaningful way. Many foundations are organized around a strict division between giving and investing.

The foundations in our study were almost evenly divided between those that make PRIs and those that do not, making our sample decidedly unrepresentative of US foundations as a whole. Most foundation staff whose organizations make PRIs commented that they would look favorably upon investing in a SIB that furthers their core mission—but then added that there were very few viable deals as yet.

Handing Off: Identifying an Exit Strategy

A number of our interviewees were concerned about the heavy participation of philanthropy in early SIB deals, and wondered whether foundations would be able to exit this role in a reasonable timeframe. There was also some uncertainty around the long-term vision for SIBs; would foundations hand off the market to mainstream impact investors, or would government take on the responsibility for scaling up proven interventions? One industry expert noted that, in his view, SIBs are "a mechanism for raising short-term capital to support prevention or intervention programs until public funding fills its place."

Many others, however, focused on the more immediate question of how and when philanthropic grantors would be able to hand off the market to mainstream impact investors. These respondents voiced worry that early, philanthropy-backed deals do not lend themselves to replication or offer an exit strategy for foundations as the market evolves. One interviewee commented, “If foundations are providing very significant guarantees on private investment, then a legitimate question is whether we’ll ever get past this initial stage to very clear-eyed investment.” Another argued that when a deal provides a substantial guarantee for investors, it may not provide viable proof of the concept; early deals need to be replicable in order to add value to the space.

Some foundation staff worried about the precedent set by guarantees for investors in early deals. They expressed concern that these sweeteners may become embedded in the market and actually obstruct the hoped-for march toward self-sustainability. One foundation staff member voiced concern that the presence of large guarantees makes SIB transactions appear far riskier than they really are.[18]

Others in the market view them as a natural and wholly beneficial factor in developing the market—“training wheels” as one market observer called them.[19] The authors of a 2012 report on the SIB landscape recommend that philanthropy help accelerate the market’s growth by providing “subordinated capital, or other credit-enhancement to attract more commercial capital in the early SIB transactions with the goal of reducing philanthropic funding as specific interventions and service providers develop more investable track records.”[20]

This debate over the costs and benefits of credit enhancements and other deal subsidies in early SIB transactions is critical to the future of the SIB market; we will return to it later.

A NUMBER OF OUR INTERVIEWEES WERE CONCERNED ABOUT THE HEAVY PARTICIPATION OF PHILANTHROPY IN EARLY SIB DEALS, AND WONDERED WHETHER FOUNDATIONS WOULD BE ABLE TO EXIT THIS ROLE IN A REASONABLE TIMEFRAME.

18 The question of risk assessment in a new market with limited data points—and the difference between perceived and actual risk—is important. For a discussion of risks attached to SIBs, see Social Finance, Inc., “A New Tool for Scaling Impact: How Social Impact Bonds Can Mobilize Private Capital to Advance Social Good” (February 2012), available at http://socialfinanceus.org/sites/socialfinanceus.org/files/small.SocialFinanceWPSingleFINAL_0.pdf.

19 Steven H. Goldberg, “The Social Impact Bond Tribune” (January 2013), available at http://payforsuccess.org/sites/default/files/sib_trib_no._2.pdf.

20 Godeke Consulting, “Building a Healthy & Sustainable Social Impact Bond Market: The Investor Landscape” (2012), available at http://www.rockefellerfoundation.org/blog/building-healthy-sustainable-social.

CASE STUDY

The George Gund Foundation: Pursuing SIBs at the County Level

The George Gund Foundation

The George Gund Foundation, based in Cleveland, Ohio, began exploring SIBs when internal research on the tool in 2010 piqued their interest. Since then, the foundation has funded three strands of complementary work in support of a SIB in Cuyahoga County. First, it has made grants to catalyze the SIB development process, including support of an initial exploration of SIB applications, community education efforts, and technical assistance for the county government, which launched a specialized procurement process. Second, it funded work to expand cross-system data analysis capacity within the areas of child protection services, homelessness, and criminal justice, which foundation staff identified as promising SIB applications. Third, it provided funding to support evaluation design and review.

As a direct result of this work, the foundation anticipates that a SIB will be launched in Cuyahoga County in 2014. The foundation has started early-stage exploration of additional potential applications for this financing model, such as possible multi-jurisdiction partnerships with other governments including the State of Ohio through its technical assistance grant from Harvard Kennedy School's SIB Lab.

Although she notes myriad challenges in developing early-stage SIB deals, Marcia Egbert, senior program officer for human services at the George Gund Foundation, characterizes the foundation's experience in this area as "energizing and optimistic." She views SIBs' potential to sharpen focus on what works as a strong source of motivation, commenting "It's exciting to think that we're all in this at the beginning of something that could someday be an established tool to help our most vulnerable citizens." At the same time, she has experienced the challenges of working at the county level, especially in terms of defining public benefits, the complexity of negotiating deal terms when both commercial and philanthropic investors are at the table, and devoting essential senior staff time among all parties. Deeper understanding of the tool's mechanics as well as its limitations, Egbert says, would benefit future development efforts.

Founded in 1952, the George Gund Foundation is a private foundation supporting the arts, economic development and community revitalization, education, environment, and human services in the US. It has approximately $510 million in assets.

Reflections: Building a Robust SIB Market

A ROBUST MARKET DEPENDS ON A STRONG ECOSYSTEM, WHICH MAY BENEFIT FROM EFFORTS AROUND THREE INTERTWINED THEMES: EDUCATION, MARKET STANDARDS, AND DATA.

Thanks to leadership from a number of philanthropic organizations, the evolution of the SIB market has progressed rapidly. Although some participants are frustrated by the long and complex process of launching the first pilots in the US, few other social innovations have advanced so quickly. Their broad appeal among diverse stakeholders has helped to speed the construction of a market infrastructure to support the first pilots. Our interviews indicate, however, that much work remains to be done. At this early stage in the market, data on SIBs' performance and risk are not yet available to attract mainstream impact investors at scale. This means that philanthropic capital will remain in alliance with private investment capital for at least the short term.

Some might wonder why foundations may choose to play a continuing role in the SIB market, helping to enable mainstream impact investors to achieve a financial return on their investment in SIBs. This is a legitimate question, and our response, which was echoed by many of our interviewees, is twofold:

- *First, to the extent that SIBs achieve social benefits that promote the well-being of individuals and families in need as well as society as a whole, a successful SIB is a big win for foundations. It is not a zero-sum game; it is a model in which both foundations and investors can achieve their goals.*

- *Second, foundations can deploy PRIs to invest in SIBs alongside mainstream impact investors and earn the same return. Creating a vibrant SIB market is appealing for foundations looking to broaden their PRI portfolios and over time, may even fit the criteria of foundations making MRIs.*

Our research uncovered several recurring themes related to the continuing role of foundations in the SIB market. How these themes are addressed will determine the future path not only for foundations in this market, but for the market as a whole. The following reflections represent our thoughts, inspired and informed by the foregoing research findings as well as our own deep experience in the market, on how foundations may continue to create a robust SIB space.

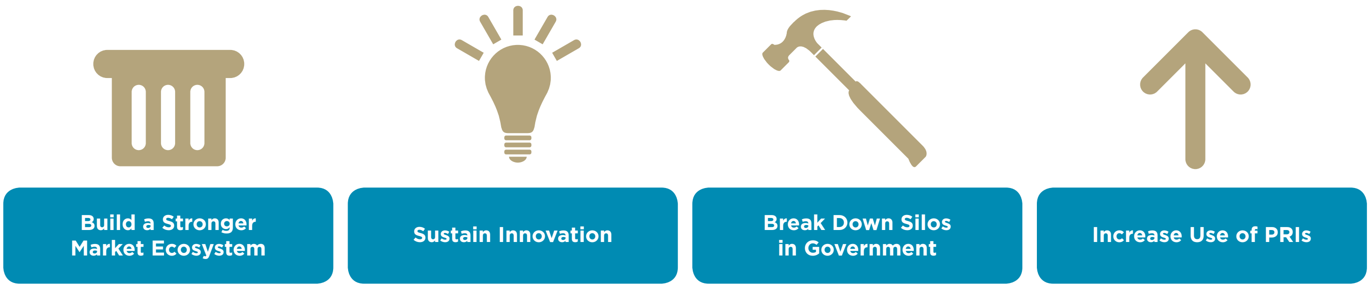


Figure 6. **How foundations can build a robust Social Impact Bond market**

Build a Stronger Market Ecosystem

With the SIB market still in its early days, the pace and quality of future developments will be closely tied to the pace and quality of market-building activity. A robust market depends on a strong ecosystem, which may benefit from efforts around three intertwined themes: education, market standards, and data.

Education

Because SIBs involve many stakeholders and each is critical to the success of the market, a strong knowledge base is essential to promote informed and productive partnerships. The complexity of the tool together with the "hype" and misconceptions around SIBs create challenges that may impede progress. This underlines the urgent need for education in this nascent arena. Market leaders could redouble their work to spearhead a coordinated and comprehensive education initiative aimed at informing government officials, building capacity among service providers, and enhancing the knowledge base of the general public.

Education efforts, which are already underway, could take the form of convenings, media outreach, training programs, and technical assistance to a wide variety of market stakeholders. The emergence of an industry network leader could also greatly facilitate field-building and a wide-ranging education initiative.

Market Standards

There is wide agreement that cohesion around industry standards would streamline the launching of new SIBs and dramatically reduce transaction costs over time. In particular, the industry would benefit enormously from the development of a standard SIB contract template, widely accepted guidelines for selecting service providers, normative outcome measurement methodology, replicable pricing models, and cash-flow schedules. While standardization may be difficult to accomplish across issue areas, efforts to streamline SIB development within a given issue area would enhance efficiency and reduce the time needed to bring deals to market.

As it may take some time and substantial experimentation before the market is able to establish replicable standards, foundations may focus first on encouraging transparency in SIB pilots. Specifically, they can advocate that government officials make SIB contracts and outcomes data available to the public to the extent it is feasible to do so. Foundation leaders can set these expectations for market participants that might be reluctant to share information publicly. By making transparency a key plank in their platform, foundations advocating for SIBs can help stakeholders succeed in learning from the first deals and creating standards over time.

Data

Data are central to the SIB's mechanics. The availability and accessibility of good-quality data provide the basis from which well-structured SIBs can be developed, priced, and launched. Data inform the need for service providers to adjust SIB-financed programming to best serve beneficiaries. Payments to SIB investors hinge on data, as well.

Through grants, convenings, and advocacy, foundations can advance efforts in improving data collection practices, ensuring accessibility in digital format, and expanding policies that facilitate data sharing. Intermediaries may be well placed to assist foundations in this area. Better data on social services would benefit SIB market development, but also aligns well with a broader shift toward better information and informed decision-making. The Office of Management & Budget, for instance, issued a memorandum in 2012 offering federal government agencies incentives for incorporating evidence into their budget requests.[21] Some foundations are already engaged on this issue. For example, the Bill & Melinda Gates Foundation and the William and Flora Hewlett Foundation, along with a for-profit partner, are supporting Markets for Good, a project to improve data in the social sector.[22] Further philanthropic support could accelerate this progress.

Sustain Innovation

Almost all of our interviewees mentioned "innovation" as a major reason for their interest in engaging with SIBs. On digging deeper, however, it turns out that there are two types of "innovation" that motivate foundations. Some are excited by the financial innovation—a new way to bring capital into the social sector to finance proven approaches to social problems. This definition of innovation refers to the financing method, not the social intervention.

Others appear to define innovation more broadly, and are excited about the prospect of using SIBs to test unproven, novel approaches to social problems. Their definition of innovation refers to the social intervention rather than the financing method. This difference may be nuanced, but it matters, especially as we in the industry work to coalesce around a long-term vision.

So what exactly is innovative about SIBs? The notion of investing in projects that can earn both social and financial returns is not new; PRI-makers at foundations and other impact investors have been doing this for decades. Pay-for-success is not an original concept; some government contracts have

ALTHOUGH SOME PARTICIPANTS ARE FRUSTRATED BY THE LONG AND COMPLEX PROCESS OF LAUNCHING THE FIRST PILOTS IN THE US, FEW OTHER SOCIAL INNOVATIONS HAVE ADVANCED SO QUICKLY.

21 Office of Management and Budget, "Memorandum to the Heads of Executive Departments and Agencies" (May 18, 2012), available at http://www.whitehouse.gov/sites/default/files/omb/memoranda/ 2012/m-12-14.pdf.

22 Markets for Good website, http://www.marketsforgood.org/.

long incorporated this feature. And underwriting performance outcomes is a time-tested practice of banks that have issued performance letters of credit,[23] which promise repayment even if the performance outcomes are not reached.

Thus the novelty of SIBs really lies in their ability to bring together a number of models that are already widely accepted in the social and financial sectors. In this sense, the SIB concept is not new; it is a hybrid of old concepts commingled in an innovative way—what Clay Christensen would call a "sustaining innovation."[24] We believe that innovation in the SIB context refers to this hybrid effect rather than to the pioneering of new and untested social services, which should fall within the purview of pure philanthropy. SIBs are an original approach to financing, by bringing financial tools to directly support social services. This philosophy is supported by leadership at a foundation that has been active in the SIB market; Judith Rodin, president of the Rockefeller Foundation, stated recently, "The innovation here is around the financial instrument, not the social delivery organization."[25]

As SIBs advance out of the pilot phase, more innovation likely lies ahead. SIB industry leaders could look for inspiration to models developed in other countries, or complementary concepts in community development finance or international finance to adapt the SIB model to other contexts and issue areas. A more knowledgeable, cohesive market could pursue these innovations even more expeditiously and collaboratively.

Break Down Silos in Government

Foundations may wish to help address the issue of silos within government by incentivizing public-sector actors to work together across traditional dividing lines. The UK's Social Outcomes Fund, for example, creates incentives for governments to pursue SIBs where public benefits cut across various sectors and levels of government. The Fund is intended to supplement outcomes payments for SIBs or other pay-for-success contracts where projects provide substantial benefits but where no single government is able to justify the entire cost. This may be a valuable model for the US. Foundations can bolster this activity through education and advocacy work, as well as grant support like that provided to the Harvard SIB Lab, which works to facilitate government's ability to work across silos more efficaciously.

Increase Use of PRIs

Our interviews suggested that there may be a number of foundations that do not make PRIs at present, but are interested in exploring this option. Those foundations would be well-served by internal capacity-building to break down any silos that may exist between investment and grantmaking operations. It is also essential that foundation boards be educated about the merits of a PRI strategy. Market intermediaries, industry organizations, and foundations with experience in PRIs can all play a role in this capacity-building effort, through a variety of channels.

Foundations that make PRIs may maximize their impact in the SIB market by pursuing several paths simultaneously—deploying grants to catalyze market development, deploying PRIs to help fund SIB-financed projects, and deploying education and advocacy efforts to mobilize public awareness and support. The Big Lottery Fund in the UK, for example, pursued a twin track in supporting the first-ever SIB: providing funds for outcome payments, and providing operating capital for Social Finance UK, the intermediary. Laura and John Arnold Foundation made a grant to a SIB intermediary, Third Sector Capital Partners, and provided philanthropic funding in the Massachusetts and New York State SIB transactions. A hybrid approach that blends traditional foundation activities such as grantmaking with market-based activities may be challenging to implement, but may hold the greatest potential to amplify impact.

23 Like all letters of credit, a performance letter of credit guarantees payment up to a certain amount by the issuing bank; in effect, the bank substitutes its credit for that of its client. A bank issues a performance letter of credit to guarantee that the customer will be paid in the event that the bank's client fails to deliver as agreed under a contract.

24 See Clayton M. Christensen, The Investor's Dilemma: When New Technologies Cause Great Firms to Fail (Cambridge, MA: Harvard Business Review Press, 1997).

25 Paul Solman, "How Modern Finance Promises to Break the Cycle of Recidivism," PBS Newshour (March 14, 2013).

CASE STUDY

Bank of America Charitable Foundation: Contributing Financial Expertise to the SIB Market

Bank of America has been closely tracking the development of Social Impact Bonds (SIBs), or pay-for-success financing options, as innovative ways to provide capital to programs that have a positive social or environmental impact. SIBs are appealing from the company's perspective for their potential to tackle problems facing communities by attracting and unlocking private capital alongside philanthropic and government funding to pursue measurable and cost-effective social outcomes. The bank's involvement with SIBs also stems from increased interest among wealth management clients for investments that can achieve social impact and financial returns.

To advance the SIB market and foster greater understanding of how these new social investments can work, the Bank of America Charitable Foundation provided an operating grant to Social Finance US in 2013. The grant helps Social Finance align the interests of diverse stakeholders, manage inherent risks, and assess whether the nonprofit service providers selected to participate in SIB deals have the capacity to achieve targeted performance benchmarks.

Beyond providing grant support, Bank of America is acting as a convener and an advocate for the SIB market. In the upcoming months, the company is hosting a roundtable to bring together investors and key stakeholders from government, nonprofits, and foundations to discuss the landscape, evolution, and approaches to impact investing. Kerry Sullivan, president of the Bank of America Charitable Foundation, notes, "As a foundation housed within a financial institution, we can provide value to the development of innovative social financing models. We see it as our responsibility to share our expertise with our clients and the general public, and to learn about new ways to invest and address social issues." Sullivan believes that foundation support is particularly critical at this stage of the market to help test and support new models of social-sector financing. In addition to the foundation, Bank of America, U.S. Trust, and Merrill Lynch are together lending their expertise to ensure that deal structures are appealing to investors, replicable, and scalable.

While the SIB market may start with a small number of commercial investors, the bank believes that SIB investment opportunities can appeal to a wide range of investors. Sullivan suggests that this is where the true test lies: if SIBs become viable opportunities for large numbers of individual investors, she notes, we will have succeeded in developing a sustainable market that creates social good.

The Bank of America Charitable Foundation is a corporate foundation that addresses needs vital to the health of communities through a focus on preserving neighborhoods, educating the workforce for 21st century jobs, and addressing critical needs, such as hunger. It is addressing these areas through a ten-year philanthropic goal of $2 billion.

New York State Social Impact Partnership: The First State-Led SIB in the US

In December 2013, Social Finance US, Bank of America Merrill Lynch, and the State of New York announced the launch of the nation's first state-led Social Impact Partnership. Uniquely, it represents the first-ever SIB offering distributed via a leading wealth management platform to private and institutional investors. The $13.5 million in raised funds will be used to expand comprehensive reentry employment services to 2,000 formerly incarcerated individuals in New York City and Rochester, New York.

This transaction sets a standard for measurement and evaluation. It is the first SIB to use a Randomized Control Trial (RCT), widely considered to be the most rigorous evaluation methodology. It ensures that government only pays for outcomes that directly result from the financed program, rather than those influenced by other factors. Moreover, the nonprofit service provider on the project, the Center for Employment Opportunities (CEO), operates an evidence-based intervention and has a culture of data collection and analysis. In 2004, CEO underwent an RCT conducted by a third-party evaluator, which found CEO's services to positively impact its participants. Additionally, CEO uses Salesforce.com, a premier data management system, to monitor participants and inform staff and management decisions. By placing importance on data and evidence, the SIB transaction enhances informed decision-making, government accountability, and taxpayer efficiency.

This pay-for-success partnership brought together the public, financial, and social sectors to achieve common goals—increase employment and improve public safety in New York—and represents a significant step toward a sustainable SIB marketplace. Each partner played an important role in the deal's development:

- ***Social Finance*** *identified the opportunity, conducted rigorous due diligence to select the provider, brought together the public- and private-sector parties that constitute the partnership, and played a central role in negotiating the transaction. It will provide ongoing performance management throughout the life of the project.*

- ***Bank of America Merrill Lynch (BAML)*** *distributed this opportunity through its wealth management platform to qualified high net worth and institutional investors via a private placement offering, a first in the SIB space. BAML is committed to transforming the instrument into an investment class that will become a standard component of client portfolios. Altogether, more than 40 investors participated in this transaction, which promises to provide a blend of financial and social returns.*

- ***Center for Employment Opportunities*** *will receive funding to expand its evidence-based training and employment services program to serve an additional 2,000 recently released inmates over a four-year period.*

AS A RESULT OF PARTICIPATING IN THE TRANSACTION, STAKEHOLDERS ACROSS SECTORS STAND TO BENEFIT SIGNIFICANTLY. MOST IMPORTANTLY, 2,000 INDIVIDUALS WILL RECEIVE THE HELP THEY NEED TO HAVE A CHANCE AT A BETTER LIFE.

- ***Laura and John Arnold Foundation*** *participated in the transaction as a funding partner, underlining its commitment to funding government accountability and evidence-based interventions.*

- ***The Rockefeller Foundation*** *provided a first-loss guarantee to protect up to $1.3 million of investor principal, or approximately 10 percent of the total investment.*

- ***The Robin Hood Foundation,*** *New York City's pioneering poverty-fighting organization, committed early to a $300,000 investment in the transaction.*

- ***Chesapeake Research Associates*** *will independently validate the results of an RCT that measures outcomes for program participants; verified social impact will form the basis of outcome payments to investors.*

Participants in this transaction all agree that the path to completion was sometimes challenging. The deal posed a number of obstacles, including the need to translate between diverse partners with differing priorities and little to no experience of working together. The bank's concern, for example, was to create a mainstream investment product, while CEO was focused on ensuring fidelity to its program model, and the state strived to ensure that taxpayers would only pay for real success. Perhaps most of all, the novelty of the deal was itself a challenge; for both BAML and the state, this was an entirely new way of doing business.

Participants also agree, however, that in the end their ability to accommodate each others' diverging interests laid the groundwork for a much stronger deal. In particular, foundations played a critical role in bringing the transaction to a successful close. The willingness of both the Rockefeller and Robin Hood Foundations to commit to the project in its initial stages was critical. The Rockefeller Foundation signed on early, providing credit enhancement and a strong signal of confidence in the transaction. The Robin Hood Foundation had invested in CEO for over ten years, and brought deep experience in rigorous evaluation. In addition, the Laura and John Arnold Foundation made a major investment, providing a solid anchor for the deal.

"Foundations played a pivotal role in this groundbreaking transaction," says Caitlin Reimers Brumme, director at Social Finance. "The leadership of key foundations, such as the Rockefeller Foundation, the Robin Hood Foundation, and the Laura and John Arnold Foundation, was a vital force in realizing the vision of accessing untapped pools of impact investment capital to more effectively fund services for those in need."

In the early weeks of service delivery, the close collaboration between the state, CEO, and Social Finance is demonstrating an exciting precedent for public-private coordination. As a result of participating in the transaction, stakeholders across sectors stand to benefit significantly. CEO will gain a flexible, predictable source of funding to expand its program; investors will have an opportunity to align their investment portfolio and social values; and government will pay only for positive results. Most importantly, 2,000 individuals will receive the help they need to have a chance at a better life.

The Way Forward

THERE IS A PRESSING NEED FOR SIB MARKET LEADERS TO OFFER A CLEAR BLUEPRINT FOR THE FUTURE. EXACTLY WHAT ROLE WILL SIBS PLAY IN SOLVING SOCIAL CHALLENGES IN THE FUTURE?

Not surprisingly, given the lack of widespread understanding and agreement on basic norms, there is a pressing need for SIB market leaders to offer a clear blueprint for the future. Exactly what role will SIBs play in solving social challenges in the future? How will the market evolve over time? How can foundations support market growth?

Foundations have played a critical and catalytic role to date. However, the patience of foundations is not infinite. Can SIBs throw off the training wheels and become completely reliant upon commercial capital? Or will SIBs continue to involve some form of philanthropic funding? And are there benefits to foundation engagement with SIBs that go well beyond the funds that they bring?

Most of our interviewees expressed the belief that eventually foundations should be able to reduce or eliminate their role as guarantors and grantors in SIB projects; the market should transition toward self-sustainability over time. There is widespread agreement that foundation participation is essential in the early stages of a new and untested tool; there is also widespread agreement that this type of grant and guarantor support should not become an embedded and necessary part of the market going forward. Foundations are now acting as midwives, facilitating the birth of a new market, but their willingness to continue playing this role indefinitely has yet to be determined.

On the other hand, some of our interviewees also expressed doubt about the desirability of SIBs evolving, in the foreseeable future, into tools that are entirely free of philanthropic participation. There is an advantage, they argue, to keeping foundations at the table even as SIBs' appeal to investors grows. Foundations offer a form of social capital or credibility that is respected by other stakeholders, especially those in the government. They supply much more than money; they also contribute long and deep experience with tackling social challenges in new and innovative ways. As noted above, they can promote transparency and data-sharing in a market where information is all-important.

CASE STUDY

The James Irvine Foundation: Catalyzing the Development of the Pay-for-Success Market in California

The James Irvine Foundation

When the James Irvine Foundation sought to identify a high-impact opportunity to support leaders with innovative ideas that would advance its mission, pay-for-success (PFS) financing quickly came to the forefront. Foundation staff saw that PFS had great momentum in the State of California; initial analysis found over a dozen leaders had initiated work on such projects, but they were often stymied by a lack of resources and proven practices to craft these complex, time-intensive agreements. The PFS model offered the potential to bring new, significant, and reliable resources to proven prevention programs—programs that could expand opportunity for Californians while also reducing costs. The possibility of influencing public policy as well as sharing knowledge gained was also appealing.

To develop an approach to support PFS innovators, the foundation turned to Nonprofit Finance Fund (NFF), which has played a prominent role in SIB market-building work since 2011. PFS would be a special initiative of the foundation, which does not have a dedicated program team to lead the work, so an important condition was the presence of a partner with the capability to implement a program. NFF was well-suited to take on the role of project coordinator. With this critical piece in place, NFF and Irvine launched the California Pay for Success Initiative with an initial grant of $2.5 million in 2014 and the possibility for an additional $1.5 million of funding, should progress be made, in 2015.

The goal of this initiative is to catalyze the development of PFS agreements in California. While there has been tremendous interest by impact investors in this model, few pay-for-success deals exist, and no such deal has tested this concept in California. The initiative will provide up to eight nonprofit and government leaders across the state, selected by NFF, with flexible funding and expert support to help them structure and close PFS agreements. While award decisions will likely prioritize projects that demonstrate the highest likelihood of arriving at signed PFS agreements within two years, projects in earlier stages of development will be eligible as well. The funding can support a variety of project needs, including cost-benefit analysis, data collection, and project management. In addition, the initiative will support peer learning so that project leaders can share and learn from their experiences. Finally, project leaders will have exposure to potential philanthropic investors, with the aim of reducing the time to bring deals to market.

Within two years of the grant awards, the initiative's goal is to have three executed PFS agreements. Don Howard, executive vice president of the James Irvine Foundation, acknowledged that this may be an audacious goal, but stressed the importance of testing the model, which he characterized as being at the intersection of several important innovative forces in the social sector, such as investing in prevention, scaling what works, impact investing, and achieving greater "bang for the buck" for public funding. He also pointed to the potential for multiplier effects. By providing support and learning opportunities to a set of PFS leaders, the initiative is designed to stimulate the creation of a stronger field of technical assistance, knowledge, and demonstration points for future projects. "We believe it's important to build the capacity of PFS leaders so that they can continue to shape this market when the initiative is over," Howard said.

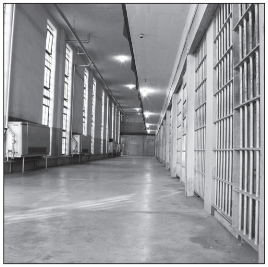
Jessica LaBarbera, director at Nonprofit Finance Fund, expressed enthusiasm for the James Irvine Foundation's groundbreaking approach, and described it as a significant learning opportunity. She characterized the initiative as both an innovative way to think about funding PFS in a space where there is still so much infrastructure to be built, as well as a model for how to deliver resources rapidly and flexibly to support innovation more quickly than traditional grantmaking. PFS, she said, is where the foundation saw an opportunity to use its funding for something that would be "disruptive, scalable, and game-changing." With regard to advancing understanding of PFS, she highlighted the fact that it is still in the proof-of-concept stage. "If we don't see demonstrated progress after two to three years, we'll need to look at that very critically," LaBarbera added. "Valuable lessons may be gleaned that can inform the broader market."

Founded in 1937, the James Irvine Foundation strives to expand opportunity for the people of California to participate in a vibrant, successful and inclusive society. With $1.8 billion in assets, the Foundation made grants of $69 million in 2013.

Others suggest that even if it were desirable to wind down foundation support of the SIB market, this goal is unlikely to be fully achieved for many years to come. Mainstream impact investors may come to contribute perhaps 80 or 90 percent of the capital for future SIB projects, they believe, but there may always be a small but significant role for foundation capital. While philanthropic entities invested £5 million in the first SIB in the UK, future deals could perhaps use the same amount structured as credit enhancement to raise £100 million from mainstream impact investors.

Moreover, since many interventions offer broad social benefits that may be difficult to monetize, it is possible to envision a future in which mainstream impact investors and foundations continue to co-fund some SIB transactions: Mainstream impact investors could fund the bulk of a SIB transaction, which may roughly correlate to the readily quantifiable benefits of the project, while foundations fund a smaller component of the transaction to support the project's difficult-to-quantify social welfare benefits. This arrangement would underline the core strength of the SIB model—its ability to facilitate multi-sector, multi-partner collaboration to generate both social and financial benefits.

As the SIB market learns and innovates from early-stage deals, SIBs will be poised to deliver future benefits as a "sustaining innovation"—technologies that improve the performance of an established product. They are the world's newest hybrid vehicle, created by the merger of existing components and holding meaningful promise for future progress. When Toyota introduced the Prius in 1997, it was the world's first commercially viable gas-electric hybrid car, and it proceeded to revolutionize the industry through its innovative mingling of two distinct power sources. Similarly, SIBs offer the potential to mingle public and private sectors; grantmakers and investors; local, state, and federal government officials; and commercial and philanthropic capital to create hybrid vehicles that are built upon a framework of true and lasting partnership in the pursuit of social progress.



FOUNDATIONS SUPPLY MUCH MORE THAN MONEY; THEY ALSO CONTRIBUTE LONG AND DEEP EXPERIENCE WITH TACKLING SOCIAL CHALLENGES IN NEW AND INNOVATIVE WAYS.

Appendix I

List of Organizations Interviewed

Anonymous foundation

The Annie E. Casey Foundation

Bank of America Charitable Foundation

The Big Lottery Fund (UK)

Bloomberg Philanthropies

The California Endowment

The Clark Foundation

The Cleveland Foundation

The Duke Endowment

The Dunham Fund

The F.B. Heron Foundation

The George Gund Foundation

Global Impact Investing Network

The James Irvine Foundation

The Joyce Foundation

The Kresge Foundation

Laura and John Arnold Foundation

New Profit Inc.

Nonprofit Finance Fund

Omidyar Network

The Pershing Square Foundation

The Piton Foundation

Richard and Susan Smith Family Foundation

Robert Wood Johnson Foundation

The Robin Hood Foundation

The Rockefeller Foundation

Third Sector Capital Partners

The W.K. Kellogg Foundation

Appendix II

Resources on Social Impact Bonds

From the United States

Center for American Progress, Series on Social Impact Bonds. http://www.americanprogress.org/series/social-impact-bonds/view/

Federal Reserve Bank of San Francisco, "Pay for Success Financing," *Community Development Investment Review* (April 2013). http://www.frbsf.org/community-development/publications/community-development-investment-review/2013/april/pay-for-success-financing/

Godeke Consulting, "Building a Healthy & Sustainable Social Impact Bond Market: The Investor Landscape" (December 2012). http://www.rockefellerfoundation.org/blog/building-healthy-sustainable-social

McKinsey & Company, "From Potential to Action: Bringing Social Impact Bonds to the US" (May 2012). http://mckinseyonsociety.com/downloads/reports/Social-Innovation/McKinsey_Social_Impact_Bonds_Report.pdf

Nonprofit Finance Fund, Pay for Success Learning Hub. http://payforsuccess.org

Social Finance, Inc., "A New Tool for Scaling Impact: How Social Impact Bonds Can Mobilize Private Capital to Advance Social Good" (February 2012). http://socialfinanceus.org/sites/socialfinanceus.org/files/small.SocialFinanceWPSingleFINAL_0.pdf

From the United Kingdom

Social Finance Ltd, "A Technical Guide to Developing Social Impact Bonds" (January 2013). http://www.socialfinance.org.uk/resources/social-finance/technical-guide-developing-social-impact-bonds

UK Cabinet Office, Centre for Social Impact Bonds, The Social Impact Bond Knowledge Box. http://data.gov.uk/sib_knowledge_box/

About the Authors

Jane Hughes is the Director of Knowledge Management at Social Finance where she focuses on analyzing industry trends, enhancing organizational learning, and disseminating knowledge to our key audiences. She has inhabited both the financial world and social development world and is dedicated to bringing these forces together for the benefit of all stakeholders. Most recently, Jane was executive director of World Learning's master's degree program in sustainable development in Washington, D.C., where she created and taught a course on microfinance and impact investment. She spent 17 years as an international finance professor at Brandeis University's International Business School.

Prior to her academic career, Jane was a vice president at Manufacturers Hanover Trust Company in New York. Jane has consulted, lectured, and published widely in the fields of international banking and finance; business, government, and the global economy; and international development. She co-wrote a leading textbook on international banking, and is currently working on a second edition of *Separating Fools from Their Money: A History of American Financial Scandals* (first edition, 2007). Jane graduated magna cum laude from Princeton University with a degree in French literature; she also has a master's degree from Johns Hopkins University School of Advanced International Studies, and an MBA from New York University.

Jill Scherer is an Associate Director and Grants Manager for Social Finance where she oversees the organization's foundation deliverables and grant reporting. In addition, she plays a key role in the organization's fundraising efforts by researching and writing grant applications.

Prior to joining Social Finance, Jill conducted research on how innovative finance can drive community and international development. Most recently, she was a Senior Research Analyst with the Milken Institute, an economic and financial think tank in Los Angeles. She co-authored several reports in support of Milken's Financial Innovations Labs, roundtables designed to identify financial solutions to social, economic, and environmental challenges. Her reports spanned the topics of early childhood, health, and small business growth. Previously, she worked in the private sector at Charles River Associates, a business and economic consulting firm. Jill has a Master's Degree in Public Policy from the University of California, Berkeley and a B.A. in Economics from Wesleyan University.

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SOCIAL FINANCE, INC.

Founded in January 2011, Social Finance is a 501(c)(3) nonprofit organization that is dedicated to mobilizing investment capital to drive social progress. We believe that everyone deserves the opportunity to thrive, and that social innovation financing can play a catalytic role in creating these opportunities.

We are dedicated to designing public-private partnerships that tackle complex social challenges, such as crime, unemployment, education, and health. As a market intermediary, we structure these partnerships by aligning the unique interests of all stakeholders—service recipients and providers, government and investors—to create innovative financing solutions. This work reflects our commitment to driving social progress through a market-based approach, as well as our experience in the governmental, capital markets, social services, and philanthropic sectors.

Core to our work is the development of Social Impact Bonds (SIBs), which draw upon private capital to fund effective interventions designed to address the needs of underserved individuals. Social Impact Bonds have the potential to unlock a new and vast pool of investment capital to finance the expansion of prevention-based projects, while focusing on measurable outcomes and generating social and financial returns for investors.

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Any errors or omissions are ours alone.

This paper was written by Jane Hughes and Jill Scherer.

Table of Contents

Foreword

Rockefeller Foundation
Innovation for the Next 100 Years

For the past century, The Rockefeller Foundation's mission to promote the well-being of humanity has been marked by a strong commitment to both innovation and collaboration to solve some of the world's most pressing challenges, whether it was developing a vaccine for the yellow fever outbreak of the early 20th century or the Green Revolution that fed more than a billion people in Latin America and Asia. The challenges of our 21st century world call for no less—particularly as crises continue to outpace our best responses.

Private markets are needed to find and finance forward-looking solutions—and philanthropy is well-suited to help engage new capital, by peeling back the first layer of risk and developing the infrastructure for innovative finance to take root. This is why The Rockefeller Foundation has been an early innovator and funder of the ecosystem for Social Impact Bonds (SIBs), an innovative finance mechanism aimed at scaling social interventions to deliver a measurable benefit for society. From early support for Social Finance UK and the pilot SIB program in Peterborough, UK, the Foundation has committed itself to facilitating the development and testing of this innovative finance model.

Although SIBs are a relatively new tool, it has rapidly garnered support as an innovative approach to financing valuable social programs without putting taxpayer dollars at risk. SIBs are marching closer to achieving "proof of concept," at which point, the sustaining market for SIBs will no longer require philanthropic capital.

But until then, philanthropy will continue to play a pivotal role. Over the last three years, The Rockefeller Foundation has helped to build the SIB ecosystem in the United States by providing planning grants to intermediaries and service providers; funding research focusing on political trajectories, the investor landscape, and social applications; and supporting first-mover mayors' and governors' offices to increase their capacities to negotiate, structure, and execute bonds.

Philanthropy is now looking to the future by exploring possible adaptations of the SIB model to environmental and international development causes. We hope that by collecting and sharing the experiences of various foundations and partners, this report will serve to accelerate the innovation and further development of SIBs for the benefit of the poor and vulnerable, and for the well-being of all humanity, throughout the world.

Judith Rodin

Judith Rodin
President, The Rockefeller Foundation

When John D. Rockefeller created the Rockefeller Foundation in 1913, he never envisioned the innovations of impact investing and Social Impact Bonds (SIBs) that his successors are supporting a hundred years later. His core message, however, lives on: Philanthropy should be deeply engaged as a laboratory of research and development for new paths of social innovation.

My colleagues interviewed thought leaders at 30 different foundations and organizations for this study in order to gather their stories and early experiences for the benefit of the broader philanthropic community. Within this limited sample, they found widespread agreement around the role of foundations in testing innovations such as SIBs. Over and over, foundation program officers and executives remarked on their institutions' willingness and ability to take on risks in support of SIB initiatives, and to seed the emerging market through its early, uncertain stages.

We at Social Finance are deeply cognizant of—and profoundly grateful for—the backing of philanthropic organizations in laying the foundation for the development of the SIB market. Indeed, it would not exist today without the support of these organizations. The first SIBs in both the US and UK were launched thanks to the support of foundations. Most recently, foundation support was vital in the two transactions announced in winter 2013-14 in Massachusetts and New York State, both of which feature substantial participation from major foundations.

At nearly $50 million, the US SIB market is now the largest in the world. Yet, this market is still far from maturity—and still, accordingly, dependent upon foundations that are willing to take on the risks of developing this high-beta, early-stage innovation. Foundations are uniquely capable of taking a long-term view by providing the patient capital that is essential to advancing the use of this innovative financial tool. Moreover, foundations provide much more than money; the thought partnership and intellectual capital that they bring to the table are equally important in shaping the SIB market.

What can philanthropy do now to accelerate progress and drive the development of a standardized, widespread SIB market in the US? And how will the role of foundations evolve as the market evolves? If the role of foundations is to incubate new initiatives, then who expands on their work once the incubation period is over? Is there an exit strategy for foundations, after they have laid the groundwork for a sound and stable SIB market by helping to build an ecosystem, refine the concept, and unlock capital? Or will they remain involved in an advisory capacity, lending their knowledge, integrity, and credibility?

This study sets out to explore philanthropy's role as innovator, funder, investor, and advisor in the SIB market, by drawing on Social Finance's on-the-ground experience as well as the rich and varied contributions of our interviewees and reviewers. We are greatly indebted to those who so generously lent their time, expertise, and wisdom to our work.

We look forward to your feedback and shared learnings.

Tracy Palandjian
CEO, Social Finance, Inc.

Executive Summary

THE US SIB MARKET HAS EVOLVED SWIFTLY FROM CONCEPT TO LAUNCH—DUE IN LARGE PART TO THE CATALYTIC SUPPORT OF FOUNDATIONS.

The provision of social services in the United States has entered a new era marked by two powerful forces: mounting pressure on government and philanthropic resources, and innovation in the social sector. These trends are intertwined; high demand for social services in combination with strained budgets call for innovative approaches to complex social challenges and new ways to finance them. Social innovation financing, especially Social Impact Bonds (SIBs), has emerged as a promising way to finance proven social services programs, fund what works, and drive government accountability.

The US SIB market has evolved swiftly from concept to launch—due in large part to the catalytic support of foundations. What has driven foundations to engage with this new form of social-sector financing? What roles have they undertaken, and how do they view their experience so far? Based on our on-the-ground experience as well as interviews with staff at foundations at all stages of engagement with the market—from observers to the actively involved—we set out to explore these questions in the context of the US market.

Our research indicates that the foundations that have chosen to engage with this nascent market are doing so for a number of reasons and in a variety of ways. They are attracted to the tool's potential to shift funding from remediation to prevention, focus on outcomes, encourage government efficiency, foster collaboration, amplify impact, and deploy capital through program-related investments (PRIs). Many viewed foundation engagement with SIBs as a natural outgrowth of philanthropy's traditional role as an "idea shop" that may take on the risk of proving a concept before it can be scaled by government.

Foundations are choosing multiple channels of engagement. They are supporting the creation of a SIB ecosystem and building a track record for this new tool by:

- ***Making grants*** *to support capacity building among key market participants, conduct research and encourage learning, develop proof-of-concept projects, pay for outcomes, and mitigate risk.*
- ***Investing*** *directly in SIB transactions through PRIs, recoverable grants, and other forms of investment.*

- ***Fostering partnerships*** *among stakeholders by helping to bring together the various and diverse actors in this space, and helping to unite them around shared goals.*

- ***Advocating and educating*** *to influence policy, attitudes, and knowledge, both among the general public and among those directly involved in SIBs, such as government officials and service providers.*

Despite the wealth of activity, substantial challenges remain before the potential of SIBs evolves into the reality of a self-sustaining market. Foundations entering the market are likely to encounter a steep learning curve and a lack of precedent on which to base transactions. Many interviewees expressed concern with the slow progress and unexpected complexity encountered in developing early SIB transactions in the US. Extra effort is required to align the interests of multiple sets of stakeholders. Silos within government across levels (local, state, national) and agencies may further stymie collaboration, while divisions within foundations between the grantmaking and investment sides may impede investment in deals. A lack of standardized, high quality data on the impact of social programs may also present obstacles. Weak data, for instance, could lead to unintended consequences and the misallocation of resources.

Finally, our interviews revealed substantial uncertainty around the long-term vision for SIBs. Specifically, foundation staff questioned how long the market would require philanthropic support and whether the ultimate goal was to hand off social services financing to mainstream impact investors[1] or government. There was much debate over the costs and benefits of credit enhancements in early SIB transactions. Some argued that philanthropy should help to seed the nascent market, but should then seek to hand off SIBs to mainstream impact investors as the market matures. Others believe that foundations bring much more to the market than just capital—they bring knowledge, integrity, and credibility—and thus should remain engaged for the long term.

Indeed, foundations may play a vital role in building a stronger market ecosystem by helping to educate market participants, including government and service providers, on the nuances of SIBs. As widely respected institutions, they are well-positioned to encourage the adoption of better data systems and urge for transparency in SIB contracts and outcomes, which are critical elements in building the industry. Foundations can also draw upon their extensive experience in the social sector to steer the conversation about how pay-for-success strategies can be adapted in different contexts to achieve better results. They can use their deep knowledge of both issue-area research and program operations to provide insight into best practices, and to ensure that individual SIB transactions maximize the opportunity to serve the public good.

Over the near term, the willingness of philanthropic institutions—large and small, corporate, national and community-based—to encourage experimentation and create the building blocks for this new market may go a long way toward realizing its potential: bringing effective programs to many more individuals in need. Further out, foundations may exit the market as the funding of proven social programs increasingly gets taken up by investors or the government. Alternatively, it is possible to envision a future in which mainstream impact investors, governments, and foundations continue to co-fund some SIB transactions for interventions with broad social benefits that may be difficult to monetize. This arrangement would underline the core strength of the SIB model: its ability to facilitate multi-sector, multi-partner collaboration to generate both social and financial benefits.

1 "Mainstream impact investors" in this context refers to institutional investors and high net-worth investors and family offices that make investments to generate financial returns and intentionally improve social or environmental outcomes.

What Is a Social Impact Bond?

A Social Impact Bond is an innovative financing mechanism designed to raise private-sector capital to expand effective social service programs. SIBs are a way to finance pay-for-success contracts, which allow government to pay only for results. If a program funded by SIBs achieves successful outcomes,[2] which are defined and agreed upon in advance by all parties to the contract, government repays investors their principal plus a rate of return based on the program's success.[3] If outcomes are not achieved, on the other hand, government is not obligated to repay investors.

As currently conceived, SIBs are only appropriate for specific problems that meet key criteria. A project is a good candidate for SIB financing if the issue area falls within a policy priority for the participating government and the project has:

- *Strong and committed government leadership with the will and ability to champion the project;*
- *Proven interventions delivered by experienced service providers with the ability to scale up their work;*
- *Potential for high net benefits, such that the anticipated benefits from the program justify the costs of implementation;*
- *Robust data availability and analysis, enabling credible outcomes measurement in a reasonable timeframe, based on a well-defined population of sufficient sample size; and*
- *Safeguards against unintended adverse consequences.*[4]

SIBs are one tool within the wider impact investing market, which offers the potential to draw large sums of private capital to the effort of solving complex social problems. By leveraging a new source of capital to fund social services, impact investing tools like SIBs provide an opportunity to accelerate progress on longstanding issues by scaling up effective programs to reach many more people in need than would be possible through grant or government dollars alone. For foundations that make mission- or program-related investments, this impact can be even more powerful as foundations are able to recycle their capital into other projects to support their missions.

Like other impact investments, SIBs involve the participation of investors who bring market discipline to transactions. Similar to many foundations, these investors conduct due diligence to ensure that participating service providers have a track record of positive results, the management capacity to grow their operations successfully, and a culture of collecting and using data to improve performance. During the course of the project, investors expect intermediaries to provide ongoing performance management and implement midcourse corrections as needed. Further, they require that decisions surrounding repayment be based on accurate social and financial data and transparent performance metrics. Their attention to performance management and tangible, quantifiable evidence drives improved outcomes.

Despite their name, Social Impact Bonds differ from municipal bonds and other fixed-income tools that are often used for infrastructure or other capital projects. SIBs share features of both debt and equity. The instrument has a fixed term and the upside is capped, but, like equity, returns vary based on performance and investors bear a higher risk of losing their principal. Moreover, these investments are not secured by hard assets or cash flows. Despite the dissimilarity to typical bonds, SIBs do in fact possess a number of bond-like characteristics, and it is worth noting that bonds are hardly uniform instruments—they come with different features, from zero-coupon bonds to convertible bonds. Similarly, the structure of each SIB will likely vary from project to project.

2 Historically, government payment to service providers has been based on outputs rather than outcomes. The metrics associated with outputs usually focus on head count, for example the number of people enrolled in a program or the number of families served. Outcomes measurement, by contrast, focuses on the impact of the service with regard to achieving desired benefits, such as the reduction in prison recidivism or the number of people who gain long-term employment as a result of the program.

3 For more information about SIBs, please see the list of resources in Appendix II.

4 Jeffrey Liebman and Alina Sellman, "Social Impact Bonds: A Guide for State and Local Governments" Harvard Kennedy School Social Impact Bond Technical Assistance Lab (June 2013), available at http://hkssiblab.files.wordpress.com/2012/11/social-impact-bonds-a-guide-for-state-and-local-governments1.pdf.

Introduction

SOCIAL INNOVATION FINANCING, ESPECIALLY THE SIB, HAS EMERGED AS A PROMISING WAY TO SCALE PROGRAMS AND REACH GREATER NUMBERS OF INDIVIDUALS IN NEED.

Are Social Impact Bonds the Same as Pay For Success?

SIBs are sometimes equated with pay-for-success (PFS) contracts, but the terms are not synonymous. In fact, PFS refers to a type of contract between government and another entity in which pay is linked to performance. The government may promise to pay a service provider when it places an individual in a job and when this person is still at the job for a year; this is a PFS contract, since pay is contingent upon performance. A SIB, by contrast, is a financing mechanism that supports PFS contracts; the SIB is used to provide upfront funding to service providers engaged in PFS contracts. All PFS-based financing arrangements in the social sector, including SIBs, fall under the wider umbrella of social innovation financing.

Governments at all levels are confronting a new era of scarcity. Coping with the lingering effects of the recession, many states and localities are struggling to meet even the essential needs of their citizens. Governments are facing tough choices between making longer term investments in preventative programs and having adequate funds to focus on near-term challenges.[5] And there is no end in sight: experts predict that federal, state, and local governments will face growing fiscal pressures for the foreseeable future.[6] While philanthropy can help, it too faces substantial funding pressures, and cannot meet the large and growing social needs.

The good news is that innovation in the social sector is flourishing. Social entrepreneurs are crafting new approaches to complex social challenges, and an increasing focus on evaluation and data is producing greater knowledge of what works, what may not work, and why. A growing cadre of investors interested in generating social impact alongside financial return is directing substantial new resources to the sector. Within this sphere, social innovation financing, especially the SIB, has emerged as a promising way to scale programs and reach greater numbers of individuals in need.[7]

The speed with which the SIB market has progressed reflects broad interest in SIBs as one way to address current challenges in financing social services. Although the world's first SIB was launched in 2010 in the UK, additional SIB-financed projects have been initiated or are in the pipeline in a number of US locations, such as California, Connecticut, Illinois, Massachusetts, New York, Ohio, South Carolina, Texas, and Utah. Much of this progress can be traced to the catalytic role that foundations are playing in the development of the nascent market.

5 States, for example, have increasingly relied on spending cuts to balance budgets. Between 2008 and 2012, state budget gaps led to a cumulative $290 billion in across-the-board spending cuts in health, education, and human services. By fiscal year 2012, most states were spending less in real terms than they did in 2008, even though the cost of services had increased. Source: Center on Budget and Policy Priorities, "Out of Balance: Cuts in Services Have Been States' Primary Response to Budget Gaps, Harming the Nation's Economy" (April 2012), available at http://www.cbpp.org/cms/index.cfm?fa=view&id=3747.

6 United States Government Accountability Office, "State and Local Governments Fiscal Outlook: April 2013 Update," available at http://www.gao.gov/assets/660/654255.pdf.

7 While we acknowledge that SIBs may be used to finance new and untested approaches to social challenges, Social Finance believes that the appeal of SIBs lies in their ability to finance the scaling-up of evidence-based interventions. It is important to underscore that SIBs do not replace government spending for social services; rather, they can redirect government spending toward what works. Even when supporting interventions with a track record of success, however, SIBs carry the risk of poor execution related to the scaling-up process itself.

Public and private foundations—those non-governmental organizations established to make grants for charitable purposes—are helping to build the market's infrastructure and demonstrate the tool's capacity. The Rockefeller Foundation invested in the first SIB in the UK and has since made a number of grants in support of building the US market. Bloomberg Philanthropies provided credit enhancement for a SIB in New York City and as a result helped attract the participation of commercial capital. Other foundations are providing operating capital to market intermediaries, funding demonstration projects, and developing deals alongside government officials.

What has driven foundations to engage with this new form of social-sector financing? What roles have they undertaken, and how do they view their experience so far? What are their concerns? How long will philanthropy play a role in the SIB market? Based on our on-the-ground experience as well as interviews with staff at foundations at all stages of engagement with the market—from observers to the actively involved—we set out to explore these questions in the context of the US market.

It is important to note that our interviews were primarily with staff at those foundations that have already begun to explore social innovation financing and therefore do not reflect a random sample of philanthropic organizations (see the sidebar on page 13 for a description of this paper's methodology). Our goal was to collect the early learnings of these pioneers for the benefit of the broader philanthropic community.

This paper is intended for foundation staff, board members, and donors who are interested in this innovative approach to channeling more resources to evidence-based programs, as well as other stakeholders looking to learn about the various ways that foundations may support the market.

We begin by summarizing the current state of foundation engagement in the US SIB market, primarily based on findings from our interviews with a number of foundation staff members. In this section, we explore why foundations have chosen to support this market, and how they have engaged. Based on the roles foundations have played to date, we provide a menu of options for other foundations that may be interested in getting involved. Next, we delve into some of the concerns that foundations may have about SIBs, as well as the obstacles that foundation staff and boards may encounter as they move into the market. We end the paper with reflections on the way forward, including our thoughts on how to optimize foundation participation to build a robust and self-sustaining SIB market in the US.

THE SPEED WITH WHICH THE SIB MARKET HAS PROGRESSED REFLECTS BROAD INTEREST IN SIBS AS ONE WAY TO ADDRESS CURRENT CHALLENGES IN FINANCING SOCIAL SERVICES.

Methodology

In our research for this paper, we leaned heavily upon the previous work of others who have studied this field and in-depth interviews with over two dozen foundation staff members and leaders in the nonprofit sector, as well as our own observations as an active participant in the development of the US SIB market. (See Appendix I for a list of our interviewees.) We endeavored to interview staff at foundations at all stages of engagement with the SIB market—from observers to the actively involved; however, our sample is heavily weighted toward those foundations that have already begun to explore this approach. We also strived to include foundations of different sizes, from opposite corners of the country, and supporting a variety of mission areas. In the end, however, the information that we gathered from these interviews is anecdotal rather than scientific—a varied assortment of opinions rather than a random sample—and we are careful to treat it as such. As one of our interviewees observed, "If you know one foundation, you know one foundation."

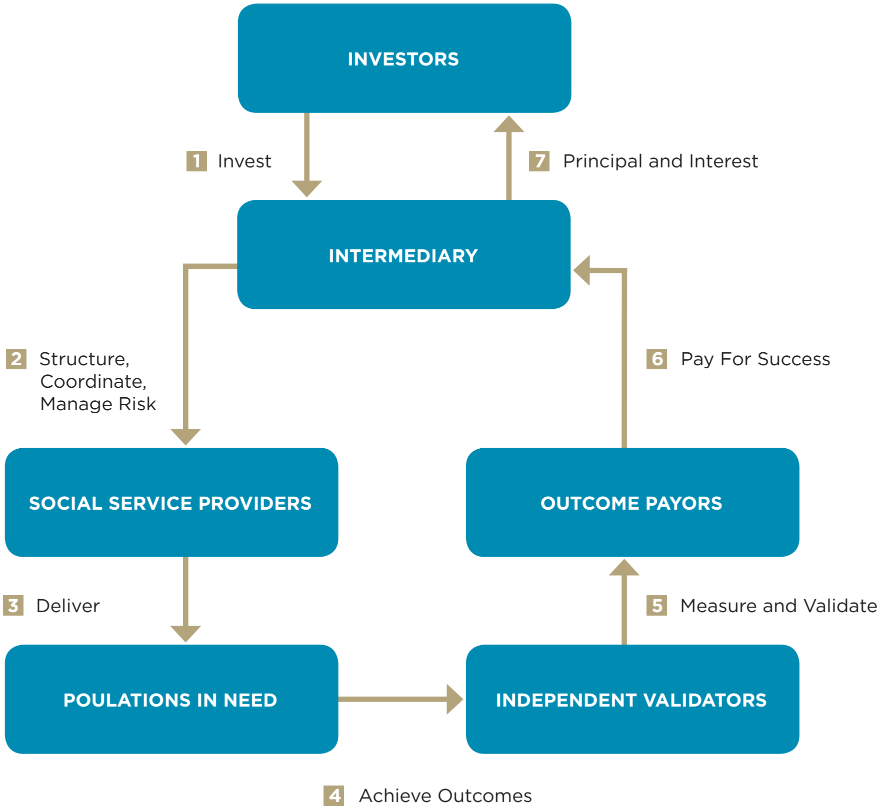
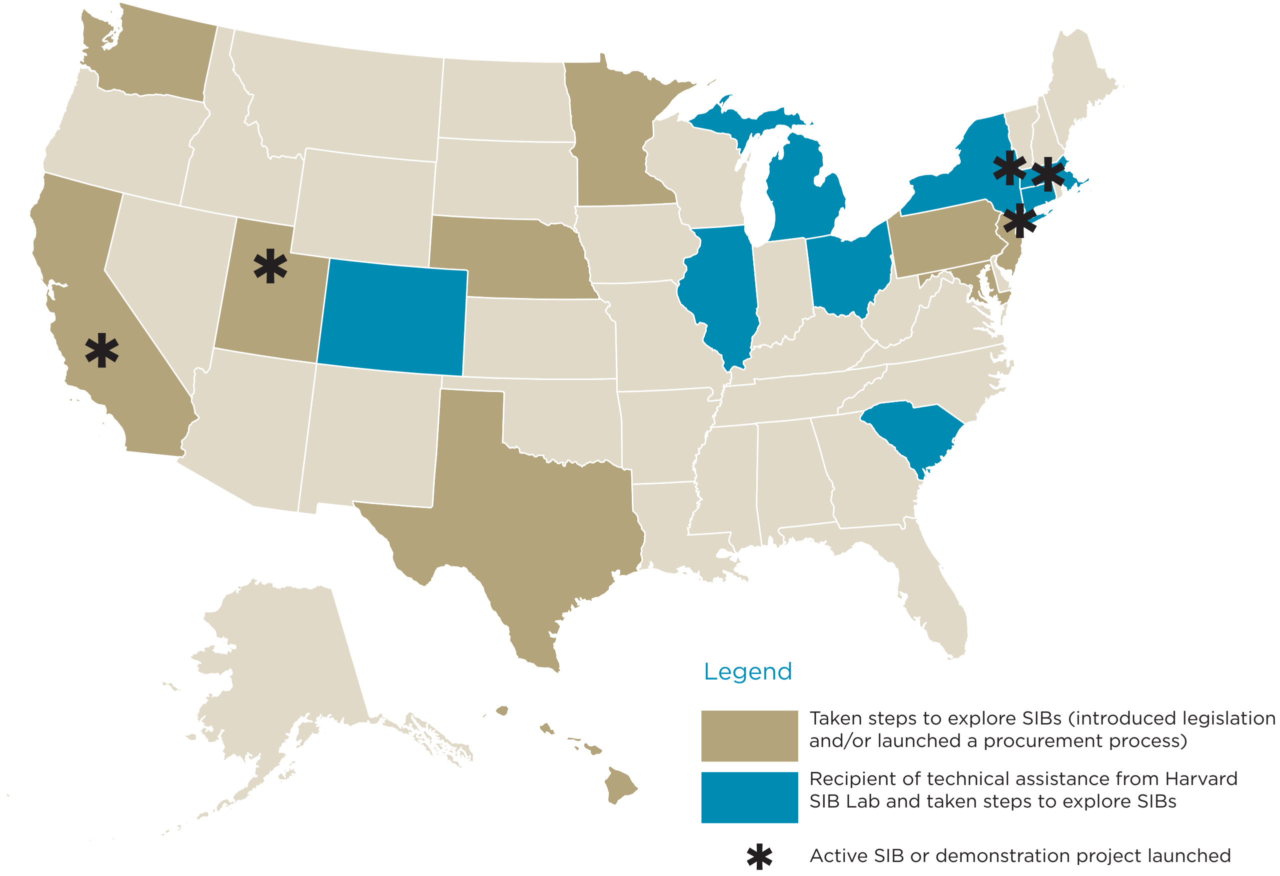


Figure 1. **How a Social Impact Bond works**

WHAT HAS DRIVEN FOUNDATIONS TO ENGAGE WITH THIS NEW FORM OF SOCIAL-SECTOR FINANCING? WHAT ROLES HAVE THEY UNDERTAKEN, AND HOW DO THEY VIEW THEIR EXPERIENCE SO FAR?



Accurate as of date of publication.

Figure 2. **Social Impact Bond activity across the United States**

ALTHOUGH THE WORLD'S FIRST SIB WAS LAUNCHED IN 2010 IN THE UK, SIB-FINANCED PROJECTS ARE IN THE PIPELINE ACROSS THE US. MUCH OF THIS PROGRESS CAN BE TRACED TO THE CATALYTIC ROLE THAT FOUNDATIONS ARE PLAYING IN THE DEVELOPMENT OF THE NASCENT MARKET.

Today's Social Impact Bond Market

The worldwide SIB market was born in the fall of 2010 in the UK, when Social Finance UK launched the first SIB. The SIB-financed program aims to reduce re-offending among men who are released from Peterborough Prison. Experienced social sector organizations will provide intensive support to 3,000 short-sentenced prisoners over a 6-year period, both inside the prison and after release, to help them resettle into the community. If this support reduces re-offending by less than 7.5 percent, the government will not repay investors. If it delivers a drop in re-offending beyond 7.5 percent, investors will receive an increasing return of up to 13 percent based upon the program's success in achieving social outcomes. Investors in the Peterborough SIB are foundations, including the Rockefeller Foundation, and philanthropic-minded individuals and families. Since launching the Peterborough SIB, the UK has remained very active in worldwide SIB development, with more than a dozen on-the-ground projects.

Pilots in the US have emerged more recently. In 2013, New York City became the first American jurisdiction to launch a SIB, and three additional deals have since been announced. The four SIBs that are now on the ground in the US are:

- ***New York City.*** *A $9.6 million project, this SIB directs capital from Goldman Sachs to a program that aims to reduce recidivism among young men exiting the Rikers Island corrections facility.*

- ***Utah.*** *Philanthropist J.B. Pritzker and Goldman Sachs are channeling up to $7.0 million to increase enrollment in a high-quality preschool program in order to reduce the need for special education and remedial services.*

- ***New York State.*** *Over 40 individual, philanthropic, and institutional investors are providing $13.5 million in funding to expand access to a workforce development program for formerly incarcerated individuals in order to boost their employment rates and reduce repeat incarceration.*

- ***Massachusetts.*** *Financed by $18 million in commercial and philanthropic funding, this SIB scales up a program delivered by a local service provider, Roca, to reduce recidivism and improve employment outcomes for young men at high risk of reoffending.*

Altogether, these deals are channeling approximately $50 million in private capital to the social sector, making the US the largest SIB market in the world in dollar terms. A number of other state and local governments are at various stages of exploring SIBs. At the federal level, President Obama has put forth support for pay-for-success initiatives in each of his budgets since 2011. The President's 2014 budget also proposed a new $300 million Incentive Fund at the Department of the Treasury to help state and local governments implement pay-for-success programs.

In addition, SIBs have commanded attention globally. In June 2013, UK Prime Minster David Cameron convened leaders from G8 member states for a Social Impact Investment Forum. Senior politicians, major philanthropists, leading investors, entrepreneurs, and business executives met to discuss the opportunities and challenges of a global impact investment market, and much discussion focused on SIBs.

Findings: Foundation Engagement with the SIB Market

FOUNDATIONS THAT FIND SIBS APPEALING AND WORTHY OF EXPLORATION HAVE A MENU OF OPTIONS FROM WHICH TO CHOOSE. BROADLY, FOUNDATIONS CAN SUPPORT SIBS IN FOUR WAYS: THROUGH GRANTMAKING, INVESTMENTS, PARTNERSHIPS, AND ADVOCACY.

The foundation staff interviewed for this paper highlighted the significant potential that many of them see in SIBs, ways that foundations may add value to the market, and challenges that may impede further activity. The next few sections provide insight into how foundations view the nascent market.

WHY ENGAGE?

Our conversations with a number of foundations point to a substantial level of support for the SIB concept. One interviewee called SIBs an "emerging jewel," while many expressed support ranging from "guarded" to "enthusiastic" for SIBs' potential to drive the expansion of evidence-based social interventions. Many were drawn to the ability of SIBs to provide flexible, patient capital at scale. Foundations that are supporting the development of the SIB market explained their reasons for participation, while others identified what they saw as the tool's most appealing characteristics.

Shift Funding toward Prevention

Many foundations are keenly aware that a significant amount of government resources are allocated toward remediation rather than prevention, and are eager to reverse this trend. The recent recession has forced many governments to make tough spending cuts, often sacrificing investments in programs that produce long-term results to ensure sufficient funds for near-term needs. As one interviewee noted, some governments have not had "the luxury of taking the future into consideration."

Several of our interviewees cited SIBs' emphasis on funding preventative programs as an appealing characteristic; as Frederick Douglass once said, "It is easier to build strong children than to repair broken men." A SIB-financed program has the potential to tackle the root causes of problems rather than just treating their symptoms. For example, a SIB targeting a reduction in asthma could finance asthma management education and the removal of home environmental triggers to reduce the need for emergency medical treatment. Indeed, the focus on prevention is really the financial engine that drives the SIB. Preventative services are designed to eliminate or vastly reduce the need for future spending on treatment services downstream, redirecting a revenue stream that enables government to repay investors.

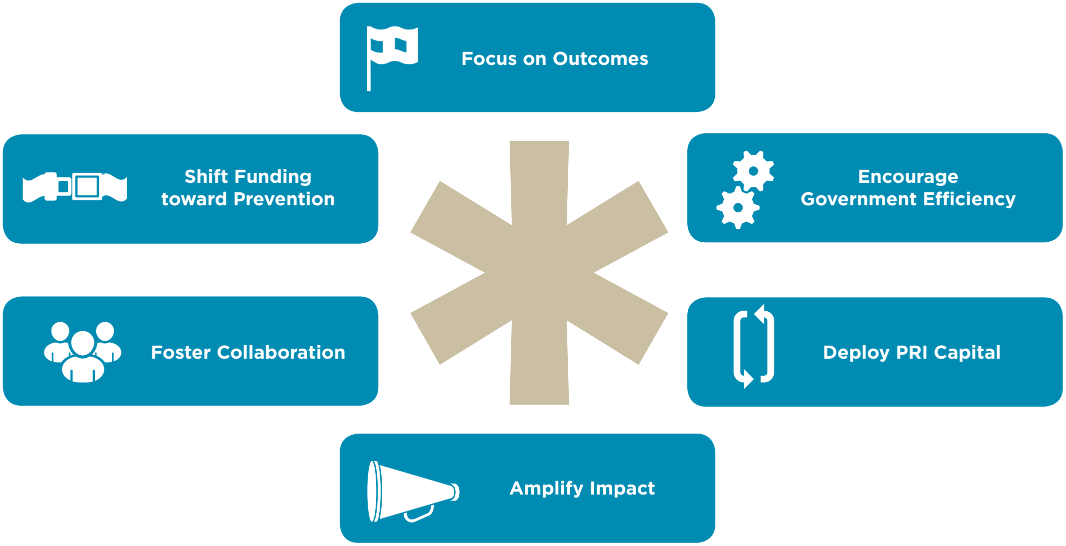


Figure 3. **Why foundations are engaging with Social Impact Bonds**

As one interviewee noted, the values of funding prevention and promoting government efficiency are not new concepts. But SIBs "raise the stakes," since actually accomplishing these objectives is no longer "a good idea or aspiration—real money is on the line."

Focus on Outcomes

SIBs' focus on outcomes was another oft-cited benefit. This focus aligns with growing interest from government, philanthropy, and the social sector in data collection, evaluation, and performance-based contracting. One interviewee commented that SIBs' "hard-nosed" approach—only rewarding what works—aligns with her foundation's interest in expanding evidence-based practices in the social sector. Because they focus on results, SIBs are not prescriptive, noted another interviewee; instead of financing a specific quantity and set of services, they allow for flexibility in service provision. This allows for "a more comprehensive approach to complex problems." An intermediary may coordinate multiple services for clients in order to meet their needs and achieve target outcomes. SIBs also commit the government and social sector to think about assessing outcomes, such as high school graduation rates, beyond the more common practice of measuring outputs, such as program completion.

Moreover, SIB-financed projects incorporate a strong component of performance management. Intermediaries and service providers manage the project closely, evaluating data on a regular basis and implementing midcourse corrections as needed. In this way, projects can evolve and adapt in order to deliver the greatest benefits.

Some foundations perceive the focus on outcomes as an important development in the social sector. They are looking beyond SIBs to the broader field of pay-for-performance. For instance, the Kresge Foundation believes that pay-for-performance structures may play an important role in service delivery going forward. To test the efficacy and efficiency of different structures, it is involved in a pilot set of pay-for-performance transactions that tie directly to the foundation's programmatic interests.

Encourage Government Efficiency

Because SIBs allow government to pay only for results, they encourage greater efficiency within the public sector. Despite growing attention to evidence in the social sector, historical funding patterns, legacy interests, and short political cycles often impede the reallocation of public dollars to the most effective interventions. Several of our foundation interviewees cited the potential of SIBs to increase accountability for taxpayer dollars. SIBs allow governments "to buy a result rather than a process," noted one interviewee. Where payments are determined by data, the public sector is assured of getting real value for its money.

This holds potential for governmental work beyond SIBs. As government officials become comfortable with the concept of pricing social outcomes, they may be more likely to incorporate outcomes data into decision-making over a broad range of areas. This should encourage efficiency by emphasizing the value of prevention over remediation, facilitating cost-benefit analysis of various interventions, and encouraging government to make evidence-based funding decisions.

Foster Collaboration

Many of our interviewees also viewed with great favor the ability of SIBs to promote collaboration; one commented, "Foundations really like to partner." By definition, SIBs draw together a number of stakeholders—government agencies, private-sector investors, service providers, beneficiaries, and intermediaries—working toward a shared purpose.

While SIB-financed projects foster cross-sector collaboration, they also have the potential to enhance the quality of these collaborations. Not only does a SIB assemble various stakeholders, but its success requires close and collegial cooperation among them. Any SIB involves internal tensions among stakeholders, and a successful transaction requires that stakeholders' incentives are aligned. In fact, each party effectively has a veto over every aspect of the enterprise. If any of them exercises that veto during the design phase, the SIB will not launch; if any of them does so during implementation, the SIB will not work. If the parties want the SIB to launch and to succeed, they have to reach consensus at the outset and maintain consensus over the life of the project.

This dynamic tension is the reason that SIBs have the potential to produce significantly greater social progress at substantially reduced expense. The system of checks and balances under the umbrella of the SIB partnership prevents any party's self-interest from undermining the pursuit of shared objectives, and keeps the partners' diverse interests in alignment.

INDEED, THE FOCUS ON PREVENTION IS REALLY THE FINANCIAL ENGINE THAT DRIVES THE SIB. PREVENTATIVE SERVICES ARE DESIGNED TO ELIMINATE OR VASTLY REDUCE THE NEED FOR FUTURE SPENDING ON TREATMENT SERVICES DOWNSTREAM, REDIRECTING A REVENUE STREAM THAT ENABLES GOVERNMENT TO REPAY INVESTORS.

For example, a government participating in a SIB may agree to a performance benchmark that incentivizes key stakeholders in the following ways:

- *The benchmark is within reach of the participating service provider, making it more likely that investors will be repaid.*
- *The benchmark is high enough to create meaningful social value for the public sector.*

Accordingly, by working together, these parties can draw upon the strengths of one another to pursue a common goal.

Amplify Impact

Foundation staff underscored the appeal of using SIBs to advance progress on their mission. Many interviewees noted that participation in this new market could enhance their mission statements. Broadly, mission alignment falls into three categories:

- ***Program area.*** *SIBs may bring a deep pool of capital to support foundations' program priorities. For example, the Joyce Foundation has deployed grant capital to fund exploration of ways in which SIBs might further its efforts in the area of workforce development, and the W.K. Kellogg Foundation is examining SIBs as a way to enable its grantees to increase their positive impact on vulnerable children.*
- ***Geography.*** *SIBs can tap resources that may be used to benefit geographies of interest. The Dunham Fund made a grant to help bring SIBs to Illinois as part of its commitment to support organizations in its community, and the James Irvine Foundation co-launched an initiative to catalyze the development of pay-for-success agreements in California.*

WHILE FOUNDATIONS ARE ENCOURAGED BY THE POTENTIAL OF SIBS TO AMPLIFY THEIR IMPACT, THEY ALSO RECOGNIZE THAT SIBS ARE COMPLEX AND LARGELY UNTESTED, HAVE POTENTIAL ONLY IN CERTAIN SETTINGS, AND ARE HARDLY A PANACEA FOR ALL SOCIAL CHALLENGES.

ability to achieve substantial impact on key areas of interest. By raising investment capital, SIBs deploy a significant new stream of funds that allows service providers to scale up their programs and reach many more individuals. As one interviewee noted, SIBs are feasible only because of recent advances in impact investing; the emergence of a growing community of investors with an interest in applying capital to achieve both financial returns and create social benefit has unlocked access to resources that "increase the pie" for the social sector.

Our conversations suggest that SIBs resonate with foundations differently depending on the nature of the alignment with their

- ***Financial innovation.*** *Foundations may be interested in SIBs primarily for their potential to apply a new financing approach to the provision of social services. The Edna McConnell Clark Foundation, for example, is helping its grantees explore SIBs as a way to connect to a large and renewable source of funding.*

While foundations are encouraged by the potential of SIBs to amplify their impact, they also recognize that SIBs are complex and largely untested, have potential only in certain settings, and are hardly a panacea for all social challenges.

CASE STUDY

The Rockefeller Foundation: A Leader in SIB Ecosystem Development

Rockefeller Foundation
Innovation for the Next 100 Years

The Rockefeller Foundation has played a strong leadership role in fostering the development of the SIB market. Starting in 2009 when the foundation made a grant to Social Finance UK to explore social innovation financing, it has been drawn to SIBs because of their intersection with impact investing and innovation, two areas of strong programmatic interest. In 2010, the foundation became the only US institution to invest in the Peterborough SIB.

As interest in the concept was escalating in the US, foundation staff believed that they could leverage the knowledge gained through their investment in the Peterborough SIB to contribute to market growth domestically. Kippy Joseph, an associate director of innovation at the Rockefeller Foundation, observed, “With every SIB, the devil is in the details. Having the firsthand experience of being in the [Peterborough] partnership was almost irreplaceable in terms of the insight that would benefit us in thinking about the US market.”

To catalyze the growth of the US market, Rockefeller has deployed nearly $10 million as part of a deliberate strategy that focused on moving SIBs from concept to pilot. In its first grants, it provided operating support to various industry players with the recognition that it would take time before market actors could finance efforts on their own. This support was comprehensive, designed to strengthen various strands of the market simultaneously. Rockefeller’s grants have seeded the field-building activities of intermediaries, government advisors, researchers, and educators, among others. To advance learning, for instance, Rockefeller provided grants to the Nonprofit Finance Fund (NFF) to create a website serving as an information platform on SIBs. It has also funded work by the Center for American Progress to develop educational materials and conduct outreach aimed at sparking a bipartisan dialogue on the topic among federal policymakers.

Over time, the foundation has endeavored to use its support to increase the comfort level with SIBs among commercial investors. Toward that end, it provided Social Finance US with a grant for credit enhancement for a specific SIB transaction. (See sidebar on page 46 for more information.) By sequencing its support in this way, the Rockefeller Foundation aims to help the market become less reliant on philanthropic support over time. Scaling SIBs with new funding sources allows prevention-oriented services to be available to vulnerable communities and prevents more expensive social problems down the line—impact the foundation seeks in its grantmaking strategy.

In addition to monetary support, the foundation has played a key networking and education role in the SIB market. Joseph explained, “As with every network, [the SIB market] really requires a network weaver to make sure that information flows freely and that while every actor is playing his or her own part in the ecosystem, there’s some sense of moving in the right direction all together. Rockefeller in some ways has played that role.” It has supported knowledge-building efforts, for instance, by connecting NFF with the White House Domestic Policy Council to shape a strong agenda for a White House convening on pay-for-success initiatives. It has also facilitated introductions between foundations and organizations working on projects of overlapping interest, and held numerous conference calls to advance learning.

Overall, Joseph characterizes the Rockefeller Foundation’s experience of creating an enabling environment for SIBs as both gratifying and challenging. She is encouraged by the energy and commitment that she sees among the various actors in the market. At the same time, assembling stakeholders from different groups and translating among them can be challenging. Ultimately, Joseph views its cross-sector, systems-level strategy as vital to realizing what the Rockefeller Foundation has identified as the real promise of SIBs: to shift more funding from remediation to prevention, enable government to use taxpayer money for successful services for vulnerable people, and unlock private capital for social benefit.

Founded in 1913, the Rockefeller Foundation’s mission is to promote the well-being of people throughout the world. It has approximately $3.5 billion in assets.

Program-Related Investments: A Primer

Private foundations are required by the IRS to give away at least 5 percent of their endowments annually, and typically invest the other 95 percent in debt, equity, and other financial instruments to maximize returns that enhance the size of their endowment. Program-related investments (PRIs) offer the opportunity for foundations to deploy their funds in a different way: as investors in socially beneficial projects.

PRIs are one form of mission investing, which refers to all investments by charitable foundations that generate both a social and financial return. Mission investments have the advantage of magnifying the impact of philanthropic dollars by providing an opportunity to earn repayment of principal plus a financial return. Thus funds can be recycled, and used to seed multiple initiatives over time.

The mission investing umbrella includes two types of tools: mission-related investments (MRIs) and PRIs. MRIs are funded from investment assets alone; they must meet the applicable prudent investor standards, and are expected to earn a market-rate financial return plus achieve social impact in line with the mission of the foundation. By contrast, PRIs are investments that may be funded from either program or investment dollars to achieve specific program objectives and are expected to return capital, often with modest returns. The IRS regulates the use of PRIs among private foundations. Although they are not subject to the same regulations, community foundations that make mission investments tend to think of them in similar categories.

Since the Ford Foundation pioneered the use of PRIs in 1968,[8] the PRI market has made considerable strides but remains limited in size and scope. In 2009, foundations made over $700 million in PRIs, compared to less than half as much a decade earlier. However, this is miniscule compared to the $40 billion in grants that foundations deployed in 2009.[9] For the past two decades, only about 1 percent of US foundations made PRIs each year.[10]

The decision of whether or not to engage in PRIs is individual to each foundation, depending mostly on its appetite for risk and innovation as well as its staff capacity and board approval. The relatively low level of PRI activity is due in part to the limited number of viable investment opportunities, high transaction costs, and thin market infrastructure. Moreover, a PRI program requires a skill set that blends mastery of financial analysis with social impact awareness and assessment—a highly unusual combination in most foundations, where program and investment staff tend to operate separately from one another.

Figure 4. **Growth in program-related investments in the United States**

Source: Lilly Family School of Philanthropy, Indiana University, "Leveraging the Power of Foundations: An Analysis of Program-Related Investing" (May 2013). PRI data comes from the IRS Statistics of Income (SOI) dataset.

8 The Ford Foundation, "Program-Related Investment," available at http://www.fordfoundation.org/grants/program-related-investment.

9 Foundation Center, "Foundation Growth and Giving Estimates: Current Outlook" (2010), available at http://foundationcenter.org/gainknowledge/research/pdf/fgge10.pdf.

10 These figures reflect the most recent data available. Source: Lilly Family School of Philanthropy, Indiana University, "Leveraging the Power of Foundations: An Analysis of Program-Related Investing" (May 2013), available at http://www.philanthropy.iupui.edu/files/research/complete_report_final_51713.pdf.

Deploy PRI Capital

By facilitating investments aimed at reducing homelessness, lowering prison recidivism rates, and addressing other persistent social challenges, SIBs provide another avenue for foundations to make program-related investments (PRIs). To date, most PRIs have directed foundation capital to bricks-and-mortar projects such as affordable housing and community facilities. (For a primer on PRIs, see the sidebar on page 22.) SIBs offer an opportunity for foundations to diversify their PRI portfolios by facilitating direct investment in human capital.[11] In this way, SIBs expand the available options in the PRI universe. Over time, SIBs may also become viable candidates for mission-related investments (MRIs), market-rate investments made out of foundation endowments.

ONE PROGRAM OFFICER EXPLAINED HER INTEREST IN SIB PILOTS BY COMMENTING, "WE HAVE THE CHARGE TO UNDERWRITE INNOVATION, TO TEST NEW MODELS IN WAYS THAT ARE MUCH HARDER FOR OTHER ACTORS LIKE GOVERNMENT TO DO."

HOW TO ENGAGE

All of our interviewees considered foundation engagement with the SIB market to be valuable, regardless of whether their organization was playing an active role. Many expressed the belief that foundations should take risks to test innovations like SIBs. One program officer explained her interest in SIB pilots by commenting, "We have the charge to underwrite innovation, to test new models in ways that are much harder for other actors like government to do."

The sense that foundations can assume risk that others cannot[12] was widespread in our small sample—as was enthusiasm for exploring new, innovative forms of financing for the social sector. The first SIB deals will be opportunities to learn, one respondent observed. Some project components will work while others will require adjustment. But foundations can absorb some of the burden of failure, from which market participants can learn a great deal. Another program officer added, "I don't see the SIB market developing without foundations. Any innovation is inherently unproven at its inception, and that's where we are now."

Indeed, this would reflect the traditional role of philanthropy as a research-and-development entity that works to prove a concept before it can be scaled by government. While this relationship was strong in the past, in recent decades it has been lacking. Restoring this dynamic would enable foundations to seed the SIB market with an eye to handing it off to other stakeholders, like government, over time.

11 Economists generally consider expenditures on housing, training, and health care as investments in human capital, which are aimed at raising earnings, enhancing health, and improving lifestyle choices.

12 At the same time, the fact that foundations have the ability to take on risks does not mean that they necessarily are willing to do so. In particular, some foundations feel that they should not be the only participant to take on risk in SIB transactions.

Foundations that find SIBs appealing and worthy of exploration have a menu of options from which to choose. Broadly, foundations can support SIBs in four ways: through grantmaking, investments, partnerships, and advocacy.

Grantmaking

Foundations can deploy grants to facilitate the ultimate development of a robust SIB market. Foundations can guide the market's evolution by providing grants to build capacity among key participants, conduct research and encourage learning, develop a proof of concept, pay for outcomes, and mitigate risk.

Build Capacity among Key Participants

- **Service providers.** Many service providers across the country oversee innovative programs that convey lasting benefits to individuals in need. However, relatively few organizations have had the opportunity to document their impact, which in turn limits their ability to attract investment. Foundations can support capacity building within service providers to improve their data collection practices and fund program evaluations in an effort to build their evidence base. Analysis of program costs versus benefits would also be helpful in clarifying the value that the services convey. Foundations that help organizations clearly demonstrate their performance can create a robust pipeline of growth-ready nonprofits—in turn, paving the way for these organizations to participate in social innovation financing transactions such as SIBs. This type of support aligns with broader efforts to foster a more data-driven social sector.

- **Intermediaries.** SIB market intermediaries play an integral role in developing, launching, and managing SIBs as well as conducting research and education to help build the market. They add value by engaging in any or all of the following activities:

  - *Research and test potential applications for SIBs,*
  - *Coordinate and align the interests of stakeholders,*
  - *Structure investments,*
  - *Support the capital-raising phase of the project, and*
  - *Provide technical assistance to service providers.*

  Intermediaries can be particularly helpful in bridging the cultural divide between investors and government, as well as in ensuring that the interests of the populations being served are protected. Over time, intermediaries—many of which are nonprofits themselves—may earn fees on SIB deals that are sufficient to cover the costs of their operations. In the meantime, foundations can support these firms as they contribute to the development of the SIB market·

FOUNDATIONS THAT HELP ORGANIZATIONS CLEARLY DEMONSTRATE THEIR PERFORMANCE CAN CREATE A ROBUST PIPELINE OF GROWTH-READY NONPROFITS—IN TURN, PAVING THE WAY FOR THESE ORGANIZATIONS TO PARTICIPATE IN SIBS.

CASE STUDY

The Pershing Square Foundation and Omidyar Network: Building Capacity within the SIB Market

The Pershing Square Foundation and Omidyar Network were two of the first foundations to support the development of the US SIB market. Additionally, Omidyar Network has supported Social Finance UK to explore the use of SIBs in an international context. Both organizations were drawn to the potential of SIBs to open up a new source of capital to fund social change. Paul Bernstein, CEO of The Pershing Square Foundation, noted that his foundation was particularly interested in the opportunity to deploy market forces to drive progress in the social sector. Amy Klement, a partner at Omidyar Network, agreed and added that SIBs have the potential to change the way that government functions. She also highlighted the tool's need for a solid evidence base, which she said the philanthropic sector can encourage and support. "Foundations can play a role in identifying the areas of potential for SIBs," she explained, "and then funding a grant to do a pilot program collecting the base case data."

Both foundations have made grants to support the growth of the US SIB market, including providing operating capital to intermediaries and other players working to develop the space. As Bernstein commented, The Pershing Square Foundation's interest is in building capacity among organizations that are, in turn, building the market. For its part, Omidyar Network supports a "sector-based" approach—encouraging systemic evaluation that encompasses an entire industry or sector and not just an individual firm or idea. Accordingly, both foundations made founding grants to Social Finance US, a SIB intermediary organization. In addition, Omidyar Network also made a grant to McKinsey & Company to fund research on the SIB market.

Both foundations have also contributed human capital—their expertise, connections, and deep knowledge—to support the development of the market. Bernstein and Klement are observers on the board of Social Finance US, and their foundations contribute technical assistance as needed. The Pershing Square Foundation and Omidyar Network have been active in helping Social Finance build its board, and Omidyar Network assists the organization with its human capital development. This work underlines the fact that foundations bring more than money to the SIB market; they also bring a vast pool of knowledge and non-financial resources that are equally valuable in moving the market forward.

The Pershing Square Foundation, based in New York, was founded in December 2006 by Karen and Bill Ackman. Bill is the CEO and Portfolio Manager of Pershing Square Capital Management, L.P. The Pershing Square Foundation has committed $225 million in grants and social investments to support exceptional leaders and innovative organizations that tackle important social issues and deliver scalable and sustainable impact.

Established in 2004 by eBay founder Pierre Omidyar and his wife Pam, Omidyar Network is a philanthropic investment firm dedicated to harnessing the power of markets to create opportunity for people to improve their lives. It has more than $275 million in assets.

CASE STUDY

Laura and John Arnold Foundation: Supporting Social Innovation Financing to Enhance Public Accountability

In recent years, cities and states across the US have struggled to balance their budgets. They have been forced to cut services, eliminate positions, and implement hiring and wage freezes. Treasurers and comptrollers have been asked to scrutinize every penny, and elected officials have had to decide which programs to keep. While the current fiscal environment has presented a number of challenges, it has also provided an opportunity to reorient government spending around outcomes and innovation. Policymakers now have a new tool, social innovation financing (SIF), which can be used to improve services to address social issues.

Laura and John Arnold Foundation (LJAF) believes SIF can help reallocate limited resources toward proven interventions that help those with the greatest needs. The private foundation, with offices in Houston and New York City, is known for its use of data and analytics to help solve some of society's most urgent and persistent problems—an approach The Wall Street Journal termed "the new science of giving." As part of LJAF's focus on public accountability, it has invested $8.4 million in SIF projects. "We identify challenges and address their root causes through innovative, multi-disciplinary solutions," LJAF vice president of public accountability Josh McGee explained. "SIF is exactly that type of tool. It has the potential to change the way government operates and provides services to those who need them the most. Private investors cover the cost of a program upfront, and the government only pays if the program is actually shown to make a difference."

LJAF provides support for the Harvard Kennedy School's Social Impact Bond (SIB) Technical Assistance Lab, the Social Impact Partnership in New York State (see page 46 for a detailed description of the project), and the Massachusetts Juvenile Justice Pay for Success Initiative. The projects in New York and Massachusetts will provide services to individuals at risk of returning to prison, and any returns on LJAF's investment will be used to support future SIF projects with the goal of rigorously evaluating programs and scaling those that are proven to have an impact. LJAF's commitment to SIF is an extension of the foundation's work in evidence-based policy-making. In 2013, the foundation committed $29.8 million to organizations that are working to encourage and facilitate government decision-making based on rigorous research and evaluation.

"By focusing on evidence and studying 'what works,' governments can ensure that taxpayer dollars are allocated in the smartest, most efficient way," McGee explained. "SIF, and its emphasis on prevention, can help transform the way government works. The tool promotes a shift from stagnant and underperforming policies toward proven and efficient programs—a practice that, regardless of the economic climate, is always fiscally sound."

Founded in 2008, the Laura and John Arnold Foundation's core objective is to produce substantial, widespread, and lasting reforms that will maximize opportunities and minimize injustice in our society.

- **Government.** Government agencies engaging in SIB development can benefit from external support in designing and implementing this unique type of public-private partnership. To support government's engagement with the model, the Rockefeller Foundation provided a grant funding the creation of the Harvard Kennedy School SIB Technical Assistance Lab, which provides pro bono technical assistance to localities that are preparing to launch SIB projects. The SIB Lab has supported SIB development work in New York State and Massachusetts, among other geographies. In early 2013, it launched a nationwide competition for other localities interested in gaining its assistance with SIB development. The SIB Lab received 28 applications, indicating widespread interest in SIBs within the public sector, as well as the desire to benefit from external expertise. It selected and is actively working with 10 governments. In addition to the Rockefeller Foundation, the Dunham Fund and the Laura and John Arnold Foundation are supporting the SIB Lab's efforts.

THE ROCKEFELLER FOUNDATION PROVIDED A GRANT FUNDING THE CREATION OF THE HARVARD KENNEDY SCHOOL SIB TECHNICAL ASSISTANCE LAB, WHICH PROVIDES PRO BONO TECHNICAL ASSISTANCE TO LOCALITIES THAT ARE PREPARING TO LAUNCH SIB PROJECTS.

Conduct Research and Encourage Learning

- **Market research.** Foundations may foster learning by funding research on the SIB market. A number of foundations, including the F.B. Heron Foundation, Omidyar Network, the Robert Wood Johnson Foundation, Rockefeller Foundation, William and Flora Hewlett Foundation, and W.K. Kellogg Foundation, supported McKinsey's 2012 report on SIBs, which outlined the US market's potential.[13] Other studies of the market could explore how pay-for-success strategies may accelerate scale in the social sector or how they can be best integrated with existing public funding streams. Lessons learned from early-stage SIB projects could also be catalogued.

- **Feasibility studies**. Not all social programs are suitable for SIB financing. Foundations can fund feasibility studies to identify a fit between the social need and the tool. Intermediaries are well positioned to carry out this analysis, which could include an assessment of the social problem, examination of evidence-based interventions, identification of growth-ready service providers, and modeling of a potential transaction's economics. Foundations may choose to support feasibility studies as a way to examine whether SIBs can help them magnify their impact within a given program area or for a target geography.

- **Information hubs.** Given the relative youth of the SIB market, a central source of neutral information about SIBs is valuable. Toward that end, the Rockefeller Foundation,

13 McKinsey & Company, "From Potential to Action: Bringing Social Impact Bonds to the US" (2012), available at http://mckinseyonsociety.com/downloads/reports/Social-Innovation/McKinsey_Social_Impact_Bonds_Report.pdf.

the William and Flora Hewlett Foundation, and the Joyce Foundation funded the Nonprofit Finance Fund (NFF) to serve as an information source on the pay-for-success model. NFF hosts a website that aggregates resources on the topic and provides assistance to service providers, government, and other stakeholders exploring this type of financing. Other foundations may consider funding complementary initiatives, such as an affinity group that connects stakeholders with an interest in this space.

Develop a Proof of Concept

- **Support demonstration projects.** With the SIB market still relatively new and untested, it is important that stakeholders maximize projects' probability of success by selecting interventions with a strong record of improving individuals' lives. Toward building a pipeline of SIB-ready interventions, a foundation may fund a demonstration project to identify scalable models for SIBs and create an evidence base from which a SIB could be designed. The California Endowment provided such a grant to Social Finance US and Collective Health for a demonstration project to fund asthma management services in Fresno, California. (See page 29 for more information on The California Endowment's support of a SIB demonstration project.) Demonstration projects may be a valuable way to improve the evidence base for interventions to support the launch of a SIB in a specific geography and facilitate its replication elsewhere.

- **Subsidize early-stage projects.** Early-stage projects can carry relatively high transaction costs, as well-established templates do not yet exist and risks are not yet well understood. To help overcome this obstacle, foundations can support SIB market development by bearing some of the costs of early-stage projects. For instance, a foundation can fund the evaluation or intermediary cost of a particular SIB deal. To support the New York City SIB transaction, Bloomberg Philanthropies made grants to MDRC, which is serving as the program intermediary, and the Vera Institute of Justice, which is providing evaluation services. One interviewee observed that support of intermediaries is especially useful in early-stage deals, since these projects may not be large enough to cover fixed costs.

Pay for Outcomes

Another way to address the high cost of early transactions is for a foundation to take on all or part of the cost of paying investors if outcomes are achieved in specific SIB transactions. While governments are currently playing the role of "payor," foundations can consider contributing to investor payments or substituting for governments in this role. By supplementing

WITH THE SIB MARKET STILL RELATIVELY NEW AND UNTESTED, IT IS IMPORTANT THAT STAKEHOLDERS MAXIMIZE PROJECTS' PROBABILITY OF SUCCESS BY SELECTING INTERVENTIONS WITH A STRONG RECORD OF IMPROVING INDIVIDUALS' LIVES.

CASE STUDY

The California Endowment: Demonstrating the Value of Upfront Funding in Chronic Health Management Programs

The California Endowment

In March 2013, The California Endowment (TCE) made a grant of $660,000 to support Social Finance US and Collective Health in launching the first phase of a demonstration project in Fresno, California. Fresno has a particularly high incidence of asthma with about 20 percent of children suffering from the chronic disease. In line with its mission to improve health outcomes in California, TCE made this grant to fund asthma home care and education for the families of 200 low-income children suffering from asthma. These proven asthma management strategies, which focus on reducing environmental triggers, are typically not funded by health insurers despite numerous studies that demonstrate their effectiveness in improving health outcomes for asthma sufferers. Without proper management, asthma can lead to unnecessary and expensive emergency room visits and hospitalizations, and can impede learning through missed days of school.

Through this project, Social Finance and Collective Health aim to demonstrate the social and economic benefits of investment in upfront asthma management services. Insurance claims data collected over the course of the project will document the cost savings due to program participants' reduced need for emergency care. The data will serve as evidence to support the case for scaling the program to reach many more children in need. In addition to overseeing the provision of asthma management services, the partners will convene an advisory group, which will work to design a SIB to scale up the program after the demonstration project is complete.

Anne Stuhldreher, a senior program manager for strategic initiatives at TCE, noted that support for this project involved substantial dialogue within the foundation. TCE program staff weighed where it could best lend value to emerging innovations in social financing. Ultimately, TCE decided to start with a small demonstration project that Collective Health and Social Finance proposed. By focusing on one locale and a programmatic area where TCE and its partners have a high level of expertise and experience, everyone involved hopes to eventually achieve scale through a social investing strategy. "If this leads to the first SIB in California, we want to lay the groundwork for it to be successful. The project wasn't ready for a SIB 6 months ago, but we hope it will be after 18 months of operations. An approach that went slower made sense for us," Stuhldreher explained.

Established in 1996, The California Endowment is a private foundation committed to expanding access to quality health care for the underserved statewide, and improving the health of all Californians. It has approximately $3.7 billion in assets.

	GRANTMAKING	INVESTMENTS	PARTNERSHIPS	ADVOCACY
Capacity building among key participants	✓			
Research and learning	✓		✓	✓
Demonstration projects and pilots	✓	✓	✓	✓
Payment to SIB investors	✓			
Risk mitigation	✓	✓	✓	✓

Figure 5. **How foundations can add value to the Social Impact Bond market**

outcomes payments made by government, foundations can facilitate scaling up of pilot projects. Foundations that pay for SIB outcomes can help bring more SIBs to market and ultimately support the creation of a track record that will be useful in attracting commercial capital to future SIB-financed projects.

Although this paper examines the US market, the UK Big Lottery Fund (BIG) provides an interesting example of how a foundation can help support the payment of outcomes. BIG committed funds for outcomes payments related to the Peterborough SIB as part of its effort to stimulate government demand for the tool and champion innovation. This commitment supplements the UK Ministry of Justice's agreement to pay for outcomes on the same transaction. While it is technically a public body, BIG operates similarly to a foundation, distributing grants of approximately £750 million per year for charitable purposes.

Foundations could pay for outcomes where governments are reluctant to participate. For instance, they could pay to expand programs that produce valuable outcomes but do not deliver net benefits within an investor-friendly timeline. Early childhood programs, among other interventions, may be good candidates for this approach because many of the benefits occur further down the line.

Mitigate Risk

Another role foundations can play is to encourage investors to direct capital into the SIB market by mitigating risk through credit enhancement of transactions. Credit enhancement decreases the financial risk of specific SIB transactions for mainstream impact investors, thus lowering the cost of capital. Credit enhancement can take the form of a financial guarantee of mainstream impact investors' capital, or a subordinated position in a transaction. In addition to grants and recoverable grants, PRIs can also be used to provide credit enhancement. The first US SIB involved credit enhancement in the form of Bloomberg Philanthropies' partial guarantee of Goldman Sachs' capital. (See page 34 for more information on Bloomberg Philanthropies' involvement with the New York City SIB.) In a SIB financing early childhood education in Utah, philanthropist J.B. Pritzker is providing a subordinated loan of up to $2.4 million to reduce the financial risk of Goldman Sachs, which is investing up to $4.6 million.

Given the lack of long-term data and experience at this early stage in market development, such credit enhancement may be desirable in some SIB transactions to help attract commercial capital. Bringing private investors into these early projects lays the groundwork for SIBs' eventual self-sustainability.

Investment

Using PRIs, foundations can become investors in the SIB market. Laura and John Arnold Foundation, for instance, made a philanthropic investment through a PRI in the New York State SIB transaction. (See page 26 for more information on the Laura and John Arnold Foundation's participation in the SIB market.) PRIs can fund entire SIB pilots, or they can be combined with commercial capital or grant money to finance transactions. When combined with investment by mainstream impact investors, foundations making PRIs can help absorb some of the costs of early transactions by accepting a lower rate of return. By investing in early-stage deals, foundations can help create proof points in the market, paving the way for commercially oriented capital to enter the space over time.

As the market matures, SIBs may be viable candidates for MRIs. They may pass the test of fiduciaries overseeing institutional assets, including foundations making MRIs, enabling access to a deep pool of capital that can be drawn upon to finance larger efforts. For the moment, staff at most of the foundations that we interviewed believe that PRIs are the appropriate vehicle for foundations wishing to invest in the SIB market.

Partnerships

Foundations can also support the development of the SIB market by fostering partnerships among stakeholders. Philanthropic organizations' deep knowledge of various stakeholders in the field—service providers, government, and intermediaries—positions them to gather the right actors to the table and facilitate meaningful conversations. Foundations can leverage this knowledge to help build constituencies that support the expansion of preventative services and evidence-based programs. They can also build on their role as conveners in various communities—both geographic and programmatic—to explore PFS partnerships with government, investors, and service providers. One interviewee noted that community foundations have a special ability to convene groups based on their deep knowledge of local issues and stakeholders.

A foundation that has worked to advance SIB partnerships among multiple sectors is the the J.B. and M.K. Pritzker Family Foundation. In March 2014, the foundation is sponsoring a convening to help stakeholders understand and develop pay-for-success contracts funding early childhood programs. The conference brings together leaders from government, finance, and the social sector, among other fields, to explore issues such as data needs, evidence, potential financing structures, and policy and legislative concerns.

Advocacy

Finally, foundations can play a role in advancing the SIB market by helping to educate key stakeholders, especially lawmakers and government officials. SIB education includes not only an explanation of how the tool works, but also the reasons for engaging with this new tool, what a developed market might look like, and why good data matters. This educational work can indirectly influence policy, attitudes, and legislation. Enabling legislation is particularly critical in paving the way for SIBs as it may provide assurance to investors that governments will follow through on their promise to pay for results. The Rockefeller Foundation funded the Center for American Progress to create educational materials and conduct outreach to advance the learning of federal policymakers around the pay-for-success concept. (See page 21 on the Rockefeller Foundation's support of the SIB ecosystem.) Some of our interviewees observed that large, national foundations may have a "comparative advantage" in broad-based research and education programs designed to improve public awareness and support of SIBs. In addition, community foundations may have greater flexibility to undertake advocacy efforts because they are not bound by the restrictions around lobbying that may constrain similar efforts by private foundations.[14]

many foundations are not accustomed to "seeing the world through an investment lens." Thus many foundations may prefer to continue engagement via direct grants to service providers.

ONE FOUNDATION EXECUTIVE ASKED, "ARE SIBS PART OF A LARGER CONVERSATION ABOUT WHAT IT WILL TAKE TO SUSTAIN A SOCIAL SAFETY NET GOING FORWARD?"

OBSTACLES & CONCERNS RELATED TO ENGAGEMENT

Foundations may encounter challenges at each phase of participation in the SIB market. Deciding whether to enter the market, navigating the space, and defining a long-term approach all present obstacles for foundation staff, who must engage in thoughtful dialogue and reflection in order to advance a SIB strategy. Our interviewees noted some of the challenges that may surface in each of these stages.

Weighing Options: Deciding Whether to Engage

Challenge Tradition

SIBs represent a new way to channel resources to the social sector. Foundations, on the other hand, have a long and venerable history—and some of our interviewees commented that such institutions do not change course lightly. By emphasizing investment and performance-based payment, SIBs disrupt the status quo method of financing social services.

Given that grant monies are a valuable and scarce resource, it is hardly surprising that some foundations would hesitate before entering this new and unproven market. Making PRIs in SIBs may be an especially big leap. As one interviewee observed,

Cut through the Hype

Furthermore, some interviewees expressed concern over the "hype." They noted that the media has devoted a great deal of attention to the emerging SIB market in the US, which stands in sharp contrast to the modest number of transactions on the ground. Moreover, a lack of proof points creates a situation in which some onlookers are questioning whether the tool can realize the anticipated benefits. One foundation executive voiced concern that some are rushing into the SIB market without enough data. While he supports investigating the SIB concept, he believes that only a few projects should be fully tested before further activity follows. Another interviewee cautioned against overselling the potential benefits of SIBs. She added that while the use of SIBs to scale proven programs would certainly be beneficial, it may only make a peripheral difference within the social sector, where so many variables affect individuals' lives. Indeed, issues surrounding poverty are multi-dimensional and complex. For example, while SIBs may be aimed at prevention of asthma-related hospital visits, they may not address the deep social ills that result in high rates of asthma among low-income children. And several

14 *For further discussion of permissible advocacy activity for foundations, see Council on Foundations, "A Foundation's Guide to Advocacy" (2010), available at http://cof.org/files/Bamboo/programsandservices/publicpolicy/documents/A_Foundations_Guide_to_Advocacy.pdf.*

interviewees noted that while SIBs may have the potential to improve some lives, they cannot effect fundamental change in the social infrastructure.

Avoid a Substitution Effect

Some interviewees also cited a concern that if SIBs are funded by grant money that would have gone to service providers anyway, this is merely a substitution—it does not contribute to "growing the pie" of resources for the social sector. To the extent that SIBs eventually attract large amounts of commercial capital, this concern would fade away. (The SIB transaction launched in New York State, described on page 46, provides an early indication of strong interest from mainstream impact investors.)

Along similar lines, some market observers cite worry that enthusiasm for SIBs will drain resources away from foundations' grant budgets and lead them down a slippery slope toward skewed priorities. A proliferation of SIBs may shift resources away from social service programs that are not good candidates for the tool, especially those with a long timeline to success or those with substantial unquantifiable benefits. Since only very specific and relatively few social programs are good candidates for SIBs at this early stage, some foundation staff may be concerned that money will be drawn to those problems and away from complex, long-term challenges.

Some interviewees also voiced concern about another form of substitution effect: SIBs taking attention away from larger, systemic reforms. One foundation executive asked, "Are [SIBs] part of a larger conversation about what it will take to sustain a social safety net going forward?" In his view, SIBs are Band-Aids that could deflect nonprofits and foundations away from broad-based work aimed at grappling with bedrock issues, such as scarcity and donor fatigue.

Overcome Knowledge Gaps

As one of our interviewees noted, there is a great deal of public and media interest in SIBs—but we still need to build deep understanding of this new tool. While many foundation staff whom we interviewed are quite familiar with the concept of social innovation financing, including SIBs, media coverage is not always accurate. For example, the term is often used interchangeably with pay-for-success, yet they have different meanings. (See sidebar on page 11 defining the difference between SIB and PFS.) SIBs are sufficiently complex instruments as to involve a learning curve; one program officer suggested that the threshold of basic understanding required for SIBs is higher compared to other endeavors.

The flexibility of SIBs adds to the confusion, as two SIBs can share a certain set of characteristics but look very different from one another. Moreover, misperceptions are common. One of our interviewees pointed to the misperception that SIBs "let government off the hook." He stressed the importance of conveying that SIBs do not replace government, but rather introduce innovation in the way that government funds social services. Indeed, government is a key partner in the development of SIBs and integral in providing the data underlying a deal's economics.

Foundations entering the SIB market must undergo a learning process that goes beyond a basic understanding of the tool. One foundation director said that before his foundation entered the market, he and his colleagues asked a lot of questions and discussed their concerns internally. They considered the value of an intermediary against its cost, as well as what criteria indicate when SIBs may be appropriate. Another interviewee mentioned the need for learning across the foundation in order to approve a grant for a SIB-related project.

Several others expressed a specific concern about the current terminology, arguing that the term "bond" is distracting at best and misleading at worst, especially in conversations with potential investors. One program officer described this as "releasing an apple into the world and calling it an orange." Another interviewee acknowledged that while "SIBs" may be a misnomer, the term has gained a certain currency at this point. He suggested that focus should shift away from discussion of terminology and toward a more comprehensive market education initiative.

CASE STUDY

Bloomberg Philanthropies: Bringing Commercial Investors to the Table

Bloomberg Philanthropies

When New York City became the first locality in the US to launch a SIB, the risk was too high and the landscape too unknown for commercial investors to become involved without some form of credit enhancement. Bloomberg Philanthropies stepped up, agreeing to guarantee 75 percent of the investor's capital through a $7.2 million grant to MDRC, a social services provider and intermediary that has designed and will oversee the program. The guarantee is structured as an evergreen facility so that if the funds are not utilized in the New York City transaction, MDRC can use them for future SIB deals. Goldman Sachs is the investor in the $9.6 million project, which aims to reduce recidivism among young men exiting the Rikers Island corrections facility. In addition, Bloomberg Philanthropies provided funding for the evaluation and intermediary costs of the transaction through grants to the Vera Institute of Justice and MDRC, respectively.

What attracted Bloomberg Philanthropies to this project? James Anderson, who leads the government innovation portfolio at the foundation, explains that two key factors motivated their participation. First, foundation staff identified the SIB model as one that could be of interest to local governments, which have come under significant and persistent budgetary pressure and are searching for ways to engage the private sector in solving public problems. SIBs align with the foundation's focus on spreading proven and promising ideas among cities. Second, the foundation was interested in using philanthropy to bring in greater support for New York City Mayor Michael R. Bloomberg's Young Men's Initiative, which was launched in 2011 to tackle the broad disparities slowing the advancement of young black and Latino men in the city. By providing a guarantee, the foundation was able to leverage $9.6 million in private dollars from Goldman Sachs, significantly expanding the pool of resources available.

Bloomberg Philanthropies and its partners in this project were well aware of the responsibility of creating the first US SIB, and that they would be setting a "standard that should live up to the promise" of the tool, in Anderson's words. Not surprisingly, the process was long and iterative, but they were determined to get this right and to blaze a path that others could follow. Now that the project is underway, Bloomberg Philanthropies is committed to learning from this SIB, and to sharing this learning with others in the field.

Anderson believes that momentum around SIBs is growing in the US, and he is optimistic about the future course of this market. Now that there are templates and models to follow, he expects that the process should become easier and transaction costs should fall. Providing the guarantee as well as funding intermediation and evaluation costs were critical to attracting private-sector capital to this first deal, he explains, but should become less important as SIBs develop a track record.

Bloomberg Philanthropies focuses on the environment, education, government innovation, and the arts. It distributed approximately $370 million in 2012.

We're In: Crafting & Implementing an Engagement Strategy

Develop a SIB Strategy

Some foundations find the SIB concept appealing, but struggle with issues around how best to support the market and when to get involved. There is significant demand for more resources within the social sector across a variety of issue areas and geographies. Where to target efforts can be challenging for foundation staff surveying the field. Although they want to participate in the SIB market, some foundations are waiting for proof points or a given level of momentum before they commit funds to the space.

Engineer Effective Implementation

The newness of SIBs also creates challenges related to participation in the early stages of a market. Several of our interviewees cited concern with the slow progress and unexpected complexity encountered in developing early SIB transactions in the US market. One staff member at a foundation that has supported an early-stage project commented that the process had not been easy, and that the final project was very different from the initial concept. Another interviewee admitted that they are "struggling" with the challenges of getting projects up and running in a timely fashion—but was quick to add that her concerns are with the abovementioned process issues, not the SIB concept itself.

SEVERAL OF OUR INTERVIEWEES CITED CONCERN WITH THE SLOW PROGRESS AND UNEXPECTED COMPLEXITY ENCOUNTERED IN DEVELOPING EARLY SIB TRANSACTIONS IN THE US MARKET.

Once a foundation has decided to enter the SIB market, staff must decide how to engage: whether to make grants or investments in the market, or support the market through advocacy, partnership development, or policy research and education. With regard to directing capital toward specific transactions, one interviewee stated that SIBs "sit uneasily between grants and investments." Another program officer questioned whether deploying grants would undermine the logic of SIBs, which are intended to produce financial as well as social returns. On the other hand, several foundations observed that SIBs may be too risky at present to qualify for some foundations' PRI portfolios—meaning that grants would be the only option. In the early stages of market development, the lack of a long-term track record for SIBs and poor understanding of risk are barriers to participation through PRIs for some foundations.

To a large extent, the challenge of building a new ecosystem from the ground up is part and parcel of the innovation process. One foundation cited a lack of templates that can be used for pilots, but suggested that as market participants gain experience through on-the-ground SIB projects, the process will become much less complicated. There is also an extra cost associated with being an early player in a new market. Foundations working on these deals emphasized the "importance of getting it right" to create examples that inspire replication.

Related to this point, however, another foundation staff member noted with concern the issue of transparency with regard to progress and outcomes of early SIB deals. Transparency is needed to accelerate the development of the

SIB market so that participants can learn from the successes (and failures) of others. There is no guarantee of transparency at present, however, partly because of privacy concerns as well as some reluctance to share learnings with potential competitors.

Make Collaboration Work across Sectors

The challenge of the collaborative, comprehensive approach is that different stakeholders' interests must be aligned at the start of the project—and remain aligned through the life of the project. As one interviewee pointed out, keeping a diverse group of partners together requires extra effort in "translation." Sometimes the foundation has to use a "different language" in working with communities, such as investors and government, that do not often collaborate.

In this context, a few interviewees expressed a specific concern about the risk of relying on government over a number of years. One underlined the risk that politics might interfere with project execution over time. He added that many of his organization's investors embrace private initiatives to tackle social challenges because of their frustration with the public sector. The passage of enabling legislation for a SIB can mitigate some of the concerns around political risk.

Avoid Unintended Consequences

Some market observers cite a worry that reliance on rigorous outcome targets will create perverse incentives and other unintended consequences. This concern highlights the importance of optimizing the design of the SIB project to avoid sending the wrong signals. A poorly designed program, for example, could incentivize participants to cherry-pick only those participants who are most likely to succeed. Other metrics can lead to poor outcomes for beneficiaries. A reduction in foster care placements, for instance, may lead to keeping children with their families even when they may be better served through other arrangements. (These problems can be avoided through the use of complementary metrics, as well as frequency rather than binary metrics.[15]) Additionally, the fact that payments to SIB investors are based on measurable outcomes raises the concern that a poorly designed SIB project could set up the wrong incentive by measuring only that which is easy to quantify.[16]

The burden that SIBs may place on participating nonprofits and the consequences of failed deals were also topics evoking uncertainty. One foundation executive had reservations about how SIBs might affect the day-to-day operations of service providers. He believed that these projects might place undue strain on the staff at participating organizations. Another executive questioned whether subjecting service providers to higher levels of scrutiny would come at a cost. For example, he wondered whether an organization with a weaker evidence base would replace a service provider that failed to achieve target outcomes.

Overcome Data Challenges

Several of our interviewees mentioned concerns about the quality of data in the social sector, especially for outcomes measurement. In transactions where payments hinge on the evaluation of program outcomes, the quality and quantity of data, they stressed, must be unimpeachable. One interviewee commented that in many cases, service providers and governments lack standardized, high quality data around the effects of service delivery, hampering their ability to participate in SIB-financed programs.[17]

As alluded to above, other market observers are unsure about the effect of measuring and quantifying only the social benefits that are more easily monetized. SIBs' emphasis on rigorous data measurement and evaluation is laudatory, but problematic at the same time. Much of the emphasis on metrics is based on hard costs, which have

15 *For further discussion of this concept, see Social Finance Ltd, "Youth Outcomes: A Guide for Service Providers and Commissioners" (October 2012), available at http://www.socialfinance.org.uk/resources/social-finance/payment-results-youth-sector.*

16 *This is "metric drift" or "metric bias" as described by Georgia Levenson Keohane in Social Entrepreneurship for the 21st Century: Innovation Across the Nonprofit, Private, and Public Sectors (New York: McGraw-Hill, 2012).*

17 *These concerns are largely addressed in a well-designed SIB. As part of the project development phase, partners pre-determine exactly what data will be required, as well as how to monitor and measure the data. This enables service providers and government to enhance their systems in advance, if needed, to ensure data integrity.*

the advantage of being objective and verifiable. But the costs of social ills—and the benefits of overcoming them—may not be wholly quantifiable. There will always be inherent limits to our ability to holistically measure costs and benefits attached to social issues. This may, in turn, raise questions about the ability of the SIB model to wholly capture the benefits associated with SIB-based projects.

Cope with Silos in the Public Sector

The issue of silos as an obstacle to SIB market development emerged as a recurring theme throughout our research. There are two kinds of silos in the public sector:

- *Vertical silos between different levels of government (local, state, national), which distribute costs and benefits unevenly; and*
- *Horizontal silos between government agencies (e.g., health, housing, corrections), which tend to fragment responses to issues that cut across all silos.*

SOCIAL PROBLEMS ARE NOT SILOED BUT MULTIFACETED, SPANNING SECTORS AND LEVELS OF GOVERNMENT ALIKE. THIS MEANS THAT RESPONSES TO THESE PROBLEMS MUST BE EQUALLY MULTIFACETED.

The problem, of course, is that social problems are not siloed but multifaceted, spanning sectors and levels of government alike. This means that responses to these problems must be equally multifaceted—but traditional divisions within government do not support this hybrid approach.

Cope with Silos in Foundations

The philanthropic sector is also somewhat siloed, marked by divisions between program and investment staff that may obstruct progress in developing the SIB market. In particular, these silos complicate the process of funding SIBs through PRIs. Many of our interviewees cited a lack of human capital capacity as an important constraint when it comes to investing in SIBs. Only a small number of foundations make PRIs, and even fewer link their investment and grantmaking staff in any meaningful way. Many foundations are organized around a strict division between giving and investing.

The foundations in our study were almost evenly divided between those that make PRIs and those that do not, making our sample decidedly unrepresentative of US foundations as a whole. Most foundation staff whose organizations make PRIs commented that they would look favorably upon investing in a SIB that furthers their core mission—but then added that there were very few viable deals as yet.

Handing Off: Identifying an Exit Strategy

A number of our interviewees were concerned about the heavy participation of philanthropy in early SIB deals, and wondered whether foundations would be able to exit this role in a reasonable timeframe. There was also some uncertainty around the long-term vision for SIBs; would foundations hand off the market to mainstream impact investors, or would government take on the responsibility for scaling up proven interventions? One industry expert noted that, in his view, SIBs are "a mechanism for raising short-term capital to support prevention or intervention programs until public funding fills its place."

Many others, however, focused on the more immediate question of how and when philanthropic grantors would be able to hand off the market to mainstream impact investors. These respondents voiced worry that early, philanthropy-backed deals do not lend themselves to replication or offer an exit strategy for foundations as the market evolves. One interviewee commented, "If foundations are providing very significant guarantees on private investment, then a legitimate question is whether we'll ever get past this initial stage to very clear-eyed investment." Another argued that when a deal provides a substantial guarantee for investors, it may not provide viable proof of the concept; early deals need to be replicable in order to add value to the space.

Some foundation staff worried about the precedent set by guarantees for investors in early deals. They expressed concern that these sweeteners may become embedded in the market and actually obstruct the hoped-for march toward self-sustainability. One foundation staff member voiced concern that the presence of large guarantees makes SIB transactions appear far riskier than they really are.[18]

Others in the market view them as a natural and wholly beneficial factor in developing the market—"training wheels" as one market observer called them.[19] The authors of a 2012 report on the SIB landscape recommend that philanthropy help accelerate the market's growth by providing "subordinated capital, or other credit-enhancement to attract more commercial capital in the early SIB transactions with the goal of reducing philanthropic funding as specific interventions and service providers develop more investable track records."[20]

This debate over the costs and benefits of credit enhancements and other deal subsidies in early SIB transactions is critical to the future of the SIB market; we will return to it later.

A NUMBER OF OUR INTERVIEWEES WERE CONCERNED ABOUT THE HEAVY PARTICIPATION OF PHILANTHROPY IN EARLY SIB DEALS, AND WONDERED WHETHER FOUNDATIONS WOULD BE ABLE TO EXIT THIS ROLE IN A REASONABLE TIMEFRAME.

18 *The question of risk assessment in a new market with limited data points—and the difference between perceived and actual risk—is important. For a discussion of risks attached to SIBs, see Social Finance, Inc., "A New Tool for Scaling Impact: How Social Impact Bonds Can Mobilize Private Capital to Advance Social Good" (February 2012), available at http://socialfinanceus.org/sites/socialfinanceus.org/files/small.SocialFinanceWPSingleFINAL_0.pdf.*

19 *Steven H. Goldberg, "The Social Impact Bond Tribune" (January 2013), available at http://payforsuccess.org/sites/default/files/sib_trib_no._2.pdf.*

20 *Godeke Consulting, "Building a Healthy & Sustainable Social Impact Bond Market: The Investor Landscape" (2012), available at http://www.rockefellerfoundation.org/blog/building-healthy-sustainable-social.*

CASE STUDY

The George Gund Foundation: Pursuing SIBs at the County Level

The George Gund Foundation

The George Gund Foundation, based in Cleveland, Ohio, began exploring SIBs when internal research on the tool in 2010 piqued their interest. Since then, the foundation has funded three strands of complementary work in support of a SIB in Cuyahoga County. First, it has made grants to catalyze the SIB development process, including support of an initial exploration of SIB applications, community education efforts, and technical assistance for the county government, which launched a specialized procurement process. Second, it funded work to expand cross-system data analysis capacity within the areas of child protection services, homelessness, and criminal justice, which foundation staff identified as promising SIB applications. Third, it provided funding to support evaluation design and review.

As a direct result of this work, the foundation anticipates that a SIB will be launched in Cuyahoga County in 2014. The foundation has started early-stage exploration of additional potential applications for this financing model, such as possible multi-jurisdiction partnerships with other governments including the State of Ohio through its technical assistance grant from Harvard Kennedy School's SIB Lab.

Although she notes myriad challenges in developing early-stage SIB deals, Marcia Egbert, senior program officer for human services at the George Gund Foundation, characterizes the foundation's experience in this area as "energizing and optimistic." She views SIBs' potential to sharpen focus on what works as a strong source of motivation, commenting "It's exciting to think that we're all in this at the beginning of something that could someday be an established tool to help our most vulnerable citizens." At the same time, she has experienced the challenges of working at the county level, especially in terms of defining public benefits, the complexity of negotiating deal terms when both commercial and philanthropic investors are at the table, and devoting essential senior staff time among all parties. Deeper understanding of the tool's mechanics as well as its limitations, Egbert says, would benefit future development efforts.

Founded in 1952, the George Gund Foundation is a private foundation supporting the arts, economic development and community revitalization, education, environment, and human services in the US. It has approximately $510 million in assets.

Reflections: Building a Robust SIB Market

A ROBUST MARKET DEPENDS ON A STRONG ECOSYSTEM, WHICH MAY BENEFIT FROM EFFORTS AROUND THREE INTERTWINED THEMES: EDUCATION, MARKET STANDARDS, AND DATA.

Thanks to leadership from a number of philanthropic organizations, the evolution of the SIB market has progressed rapidly. Although some participants are frustrated by the long and complex process of launching the first pilots in the US, few other social innovations have advanced so quickly. Their broad appeal among diverse stakeholders has helped to speed the construction of a market infrastructure to support the first pilots. Our interviews indicate, however, that much work remains to be done. At this early stage in the market, data on SIBs' performance and risk are not yet available to attract mainstream impact investors at scale. This means that philanthropic capital will remain in alliance with private investment capital for at least the short term.

Some might wonder why foundations may choose to play a continuing role in the SIB market, helping to enable mainstream impact investors to achieve a financial return on their investment in SIBs. This is a legitimate question, and our response, which was echoed by many of our interviewees, is twofold:

- *First, to the extent that SIBs achieve social benefits that promote the well-being of individuals and families in need as well as society as a whole, a successful SIB is a big win for foundations. It is not a zero-sum game; it is a model in which both foundations and investors can achieve their goals.*

- *Second, foundations can deploy PRIs to invest in SIBs alongside mainstream impact investors and earn the same return. Creating a vibrant SIB market is appealing for foundations looking to broaden their PRI portfolios and over time, may even fit the criteria of foundations making MRIs.*

Our research uncovered several recurring themes related to the continuing role of foundations in the SIB market. How these themes are addressed will determine the future path not only for foundations in this market, but for the market as a whole. The following reflections represent our thoughts, inspired and informed by the foregoing research findings as well as our own deep experience in the market, on how foundations may continue to create a robust SIB space.

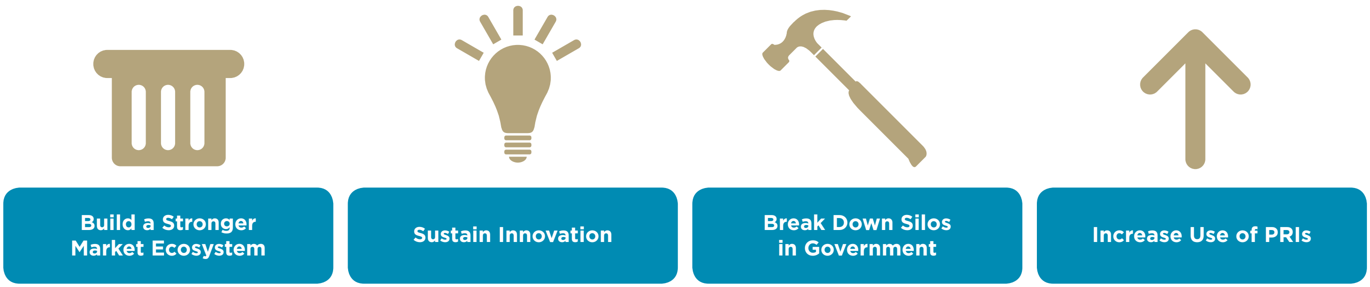


Figure 6. **How foundations can build a robust Social Impact Bond market**

Build a Stronger Market Ecosystem

With the SIB market still in its early days, the pace and quality of future developments will be closely tied to the pace and quality of market-building activity. A robust market depends on a strong ecosystem, which may benefit from efforts around three intertwined themes: education, market standards, and data.

Education

Because SIBs involve many stakeholders and each is critical to the success of the market, a strong knowledge base is essential to promote informed and productive partnerships. The complexity of the tool together with the "hype" and misconceptions around SIBs create challenges that may impede progress. This underlines the urgent need for education in this nascent arena. Market leaders could redouble their work to spearhead a coordinated and comprehensive education initiative aimed at informing government officials, building capacity among service providers, and enhancing the knowledge base of the general public.

Education efforts, which are already underway, could take the form of convenings, media outreach, training programs, and technical assistance to a wide variety of market stakeholders. The emergence of an industry network leader could also greatly facilitate field-building and a wide-ranging education initiative.

Market Standards

There is wide agreement that cohesion around industry standards would streamline the launching of new SIBs and dramatically reduce transaction costs over time. In particular, the industry would benefit enormously from the development of a standard SIB contract template, widely accepted guidelines for selecting service providers, normative outcome measurement methodology, replicable pricing models, and cash-flow schedules. While standardization may be difficult to accomplish across issue areas, efforts to streamline SIB development within a given issue area would enhance efficiency and reduce the time needed to bring deals to market.

As it may take some time and substantial experimentation before the market is able to establish replicable standards, foundations may focus first on encouraging transparency in SIB pilots. Specifically, they can advocate that government officials make SIB contracts and outcomes data available to the public to the extent it is feasible to do so. Foundation leaders can set these expectations for market participants that might be reluctant to share information publicly. By making transparency a key plank in their platform, foundations advocating for SIBs can help stakeholders succeed in learning from the first deals and creating standards over time.

Data

Data are central to the SIB's mechanics. The availability and accessibility of good-quality data provide the basis from which well-structured SIBs can be developed, priced, and launched. Data inform the need for service providers to adjust SIB-financed programming to best serve beneficiaries. Payments to SIB investors hinge on data, as well.

Through grants, convenings, and advocacy, foundations can advance efforts in improving data collection practices, ensuring accessibility in digital format, and expanding policies that facilitate data sharing. Intermediaries may be well placed to assist foundations in this area. Better data on social services would benefit SIB market development, but also aligns well with a broader shift toward better information and informed decision-making. The Office of Management & Budget, for instance, issued a memorandum in 2012 offering federal government agencies incentives for incorporating evidence into their budget requests.[21] Some foundations are already engaged on this issue. For example, the Bill & Melinda Gates Foundation and the William and Flora Hewlett Foundation, along with a for-profit partner, are supporting Markets for Good, a project to improve data in the social sector.[22] Further philanthropic support could accelerate this progress.

Sustain Innovation

Almost all of our interviewees mentioned "innovation" as a major reason for their interest in engaging with SIBs. On digging deeper, however, it turns out that there are two types of "innovation" that motivate foundations. Some are excited by the financial innovation—a new way to bring capital into the social sector to finance proven approaches to social problems. This definition of innovation refers to the financing method, not the social intervention.

Others appear to define innovation more broadly, and are excited about the prospect of using SIBs to test unproven, novel approaches to social problems. Their definition of innovation refers to the social intervention rather than the financing method. This difference may be nuanced, but it matters, especially as we in the industry work to coalesce around a long-term vision.

So what exactly is innovative about SIBs? The notion of investing in projects that can earn both social and financial returns is not new; PRI-makers at foundations and other impact investors have been doing this for decades. Pay-for-success is not an original concept; some government contracts have

ALTHOUGH SOME PARTICIPANTS ARE FRUSTRATED BY THE LONG AND COMPLEX PROCESS OF LAUNCHING THE FIRST PILOTS IN THE US, FEW OTHER SOCIAL INNOVATIONS HAVE ADVANCED SO QUICKLY.

21 *Office of Management and Budget, "Memorandum to the Heads of Executive Departments and Agencies" (May 18, 2012), available at http://www.whitehouse.gov/sites/default/files/omb/memoranda/ 2012/m-12-14.pdf.*

22 *Markets for Good website, http://www.marketsforgood.org/.*

long incorporated this feature. And underwriting performance outcomes is a time-tested practice of banks that have issued performance letters of credit,[23] which promise repayment even if the performance outcomes are not reached.

Thus the novelty of SIBs really lies in their ability to bring together a number of models that are already widely accepted in the social and financial sectors. In this sense, the SIB concept is not new; it is a hybrid of old concepts commingled in an innovative way—what Clay Christensen would call a "sustaining innovation."[24] We believe that innovation in the SIB context refers to this hybrid effect rather than to the pioneering of new and untested social services, which should fall within the purview of pure philanthropy. SIBs are an original approach to financing, by bringing financial tools to directly support social services. This philosophy is supported by leadership at a foundation that has been active in the SIB market; Judith Rodin, president of the Rockefeller Foundation, stated recently, "The innovation here is around the financial instrument, not the social delivery organization."[25]

As SIBs advance out of the pilot phase, more innovation likely lies ahead. SIB industry leaders could look for inspiration to models developed in other countries, or complementary concepts in community development finance or international finance to adapt the SIB model to other contexts and issue areas. A more knowledgeable, cohesive market could pursue these innovations even more expeditiously and collaboratively.

Break Down Silos in Government

Foundations may wish to help address the issue of silos within government by incentivizing public-sector actors to work together across traditional dividing lines. The UK's Social Outcomes Fund, for example, creates incentives for governments to pursue SIBs where public benefits cut across various sectors and levels of government. The Fund is intended to supplement outcomes payments for SIBs or other pay-for-success contracts where projects provide substantial benefits but where no single government is able to justify the entire cost. This may be a valuable model for the US. Foundations can bolster this activity through education and advocacy work, as well as grant support like that provided to the Harvard SIB Lab, which works to facilitate government's ability to work across silos more efficaciously.

Increase Use of PRIs

Our interviews suggested that there may be a number of foundations that do not make PRIs at present, but are interested in exploring this option. Those foundations would be well-served by internal capacity-building to break down any silos that may exist between investment and grantmaking operations. It is also essential that foundation boards be educated about the merits of a PRI strategy. Market intermediaries, industry organizations, and foundations with experience in PRIs can all play a role in this capacity-building effort, through a variety of channels.

Foundations that make PRIs may maximize their impact in the SIB market by pursuing several paths simultaneously—deploying grants to catalyze market development, deploying PRIs to help fund SIB-financed projects, and deploying education and advocacy efforts to mobilize public awareness and support. The Big Lottery Fund in the UK, for example, pursued a twin track in supporting the first-ever SIB: providing funds for outcome payments, and providing operating capital for Social Finance UK, the intermediary. Laura and John Arnold Foundation made a grant to a SIB intermediary, Third Sector Capital Partners, and provided philanthropic funding in the Massachusetts and New York State SIB transactions. A hybrid approach that blends traditional foundation activities such as grantmaking with market-based activities may be challenging to implement, but may hold the greatest potential to amplify impact.

23 Like all letters of credit, a performance letter of credit guarantees payment up to a certain amount by the issuing bank; in effect, the bank substitutes its credit for that of its client. A bank issues a performance letter of credit to guarantee that the customer will be paid in the event that the bank's client fails to deliver as agreed under a contract.

24 See Clayton M. Christensen, The Investor's Dilemma: When New Technologies Cause Great Firms to Fail (Cambridge, MA: Harvard Business Review Press, 1997).

25 Paul Solman, "How Modern Finance Promises to Break the Cycle of Recidivism," PBS Newshour (March 14, 2013).

CASE STUDY

Bank of America Charitable Foundation: Contributing Financial Expertise to the SIB Market

Bank of America has been closely tracking the development of Social Impact Bonds (SIBs), or pay-for-success financing options, as innovative ways to provide capital to programs that have a positive social or environmental impact. SIBs are appealing from the company's perspective for their potential to tackle problems facing communities by attracting and unlocking private capital alongside philanthropic and government funding to pursue measurable and cost-effective social outcomes. The bank's involvement with SIBs also stems from increased interest among wealth management clients for investments that can achieve social impact and financial returns.

To advance the SIB market and foster greater understanding of how these new social investments can work, the Bank of America Charitable Foundation provided an operating grant to Social Finance US in 2013. The grant helps Social Finance align the interests of diverse stakeholders, manage inherent risks, and assess whether the nonprofit service providers selected to participate in SIB deals have the capacity to achieve targeted performance benchmarks.

Beyond providing grant support, Bank of America is acting as a convener and an advocate for the SIB market. In the upcoming months, the company is hosting a roundtable to bring together investors and key stakeholders from government, nonprofits, and foundations to discuss the landscape, evolution, and approaches to impact investing. Kerry Sullivan, president of the Bank of America Charitable Foundation, notes, "As a foundation housed within a financial institution, we can provide value to the development of innovative social financing models. We see it as our responsibility to share our expertise with our clients and the general public, and to learn about new ways to invest and address social issues." Sullivan believes that foundation support is particularly critical at this stage of the market to help test and support new models of social-sector financing. In addition to the foundation, Bank of America, U.S. Trust, and Merrill Lynch are together lending their expertise to ensure that deal structures are appealing to investors, replicable, and scalable.

While the SIB market may start with a small number of commercial investors, the bank believes that SIB investment opportunities can appeal to a wide range of investors. Sullivan suggests that this is where the true test lies: if SIBs become viable opportunities for large numbers of individual investors, she notes, we will have succeeded in developing a sustainable market that creates social good.

The Bank of America Charitable Foundation is a corporate foundation that addresses needs vital to the health of communities through a focus on preserving neighborhoods, educating the workforce for 21st century jobs, and addressing critical needs, such as hunger. It is addressing these areas through a ten-year philanthropic goal of $2 billion.

New York State Social Impact Partnership: The First State-Led SIB in the US

In December 2013, Social Finance US, Bank of America Merrill Lynch, and the State of New York announced the launch of the nation's first state-led Social Impact Partnership. Uniquely, it represents the first-ever SIB offering distributed via a leading wealth management platform to private and institutional investors. The $13.5 million in raised funds will be used to expand comprehensive reentry employment services to 2,000 formerly incarcerated individuals in New York City and Rochester, New York.

This transaction sets a standard for measurement and evaluation. It is the first SIB to use a Randomized Control Trial (RCT), widely considered to be the most rigorous evaluation methodology. It ensures that government only pays for outcomes that directly result from the financed program, rather than those influenced by other factors. Moreover, the nonprofit service provider on the project, the Center for Employment Opportunities (CEO), operates an evidence-based intervention and has a culture of data collection and analysis. In 2004, CEO underwent an RCT conducted by a third-party evaluator, which found CEO's services to positively impact its participants. Additionally, CEO uses Salesforce.com, a premier data management system, to monitor participants and inform staff and management decisions. By placing importance on data and evidence, the SIB transaction enhances informed decision-making, government accountability, and taxpayer efficiency.

This pay-for-success partnership brought together the public, financial, and social sectors to achieve common goals—increase employment and improve public safety in New York—and represents a significant step toward a sustainable SIB marketplace. Each partner played an important role in the deal's development:

- ***Social Finance*** *identified the opportunity, conducted rigorous due diligence to select the provider, brought together the public- and private-sector parties that constitute the partnership, and played a central role in negotiating the transaction. It will provide ongoing performance management throughout the life of the project.*
- ***Bank of America Merrill Lynch (BAML)*** *distributed this opportunity through its wealth management platform to qualified high net worth and institutional investors via a private placement offering, a first in the SIB space. BAML is committed to transforming the instrument into an investment class that will become a standard component of client portfolios. Altogether, more than 40 investors participated in this transaction, which promises to provide a blend of financial and social returns.*
- ***Center for Employment Opportunities*** *will receive funding to expand its evidence-based training and employment services program to serve an additional 2,000 recently released inmates over a four-year period.*

AS A RESULT OF PARTICIPATING IN THE TRANSACTION, STAKEHOLDERS ACROSS SECTORS STAND TO BENEFIT SIGNIFICANTLY. MOST IMPORTANTLY, 2,000 INDIVIDUALS WILL RECEIVE THE HELP THEY NEED TO HAVE A CHANCE AT A BETTER LIFE.

- ***Laura and John Arnold Foundation** participated in the transaction as a funding partner, underlining its commitment to funding government accountability and evidence-based interventions.*

- ***The Rockefeller Foundation** provided a first-loss guarantee to protect up to $1.3 million of investor principal, or approximately 10 percent of the total investment.*

- ***The Robin Hood Foundation,** New York City's pioneering poverty-fighting organization, committed early to a $300,000 investment in the transaction.*

- ***Chesapeake Research Associates** will independently validate the results of an RCT that measures outcomes for program participants; verified social impact will form the basis of outcome payments to investors.*

Participants in this transaction all agree that the path to completion was sometimes challenging. The deal posed a number of obstacles, including the need to translate between diverse partners with differing priorities and little to no experience of working together. The bank's concern, for example, was to create a mainstream investment product, while CEO was focused on ensuring fidelity to its program model, and the state strived to ensure that taxpayers would only pay for real success. Perhaps most of all, the novelty of the deal was itself a challenge; for both BAML and the state, this was an entirely new way of doing business.

Participants also agree, however, that in the end their ability to accommodate each others' diverging interests laid the groundwork for a much stronger deal. In particular, foundations played a critical role in bringing the transaction to a successful close. The willingness of both the Rockefeller and Robin Hood Foundations to commit to the project in its initial stages was critical. The Rockefeller Foundation signed on early, providing credit enhancement and a strong signal of confidence in the transaction. The Robin Hood Foundation had invested in CEO for over ten years, and brought deep experience in rigorous evaluation. In addition, the Laura and John Arnold Foundation made a major investment, providing a solid anchor for the deal.

"Foundations played a pivotal role in this groundbreaking transaction," says Caitlin Reimers Brumme, director at Social Finance. "The leadership of key foundations, such as the Rockefeller Foundation, the Robin Hood Foundation, and the Laura and John Arnold Foundation, was a vital force in realizing the vision of accessing untapped pools of impact investment capital to more effectively fund services for those in need."

In the early weeks of service delivery, the close collaboration between the state, CEO, and Social Finance is demonstrating an exciting precedent for public-private coordination. As a result of participating in the transaction, stakeholders across sectors stand to benefit significantly. CEO will gain a flexible, predictable source of funding to expand its program; investors will have an opportunity to align their investment portfolio and social values; and government will pay only for positive results. Most importantly, 2,000 individuals will receive the help they need to have a chance at a better life.

The Way Forward

THERE IS A PRESSING NEED FOR SIB MARKET LEADERS TO OFFER A CLEAR BLUEPRINT FOR THE FUTURE. EXACTLY WHAT ROLE WILL SIBS PLAY IN SOLVING SOCIAL CHALLENGES IN THE FUTURE?

Not surprisingly, given the lack of widespread understanding and agreement on basic norms, there is a pressing need for SIB market leaders to offer a clear blueprint for the future. Exactly what role will SIBs play in solving social challenges in the future? How will the market evolve over time? How can foundations support market growth?

Foundations have played a critical and catalytic role to date. However, the patience of foundations is not infinite. Can SIBs throw off the training wheels and become completely reliant upon commercial capital? Or will SIBs continue to involve some form of philanthropic funding? And are there benefits to foundation engagement with SIBs that go well beyond the funds that they bring?

Most of our interviewees expressed the belief that eventually foundations should be able to reduce or eliminate their role as guarantors and grantors in SIB projects; the market should transition toward self-sustainability over time. There is widespread agreement that foundation participation is essential in the early stages of a new and untested tool; there is also widespread agreement that this type of grant and guarantor support should not become an embedded and necessary part of the market going forward. Foundations are now acting as midwives, facilitating the birth of a new market, but their willingness to continue playing this role indefinitely has yet to be determined.

On the other hand, some of our interviewees also expressed doubt about the desirability of SIBs evolving, in the foreseeable future, into tools that are entirely free of philanthropic participation. There is an advantage, they argue, to keeping foundations at the table even as SIBs' appeal to investors grows. Foundations offer a form of social capital or credibility that is respected by other stakeholders, especially those in the government. They supply much more than money; they also contribute long and deep experience with tackling social challenges in new and innovative ways. As noted above, they can promote transparency and data-sharing in a market where information is all-important.

CASE STUDY

The James Irvine Foundation: Catalyzing the Development of the Pay-for-Success Market in California

When the James Irvine Foundation sought to identify a high-impact opportunity to support leaders with innovative ideas that would advance its mission, pay-for-success (PFS) financing quickly came to the forefront. Foundation staff saw that PFS had great momentum in the State of California; initial analysis found over a dozen leaders had initiated work on such projects, but they were often stymied by a lack of resources and proven practices to craft these complex, time-intensive agreements. The PFS model offered the potential to bring new, significant, and reliable resources to proven prevention programs—programs that could expand opportunity for Californians while also reducing costs. The possibility of influencing public policy as well as sharing knowledge gained was also appealing.

To develop an approach to support PFS innovators, the foundation turned to Nonprofit Finance Fund (NFF), which has played a prominent role in SIB market-building work since 2011. PFS would be a special initiative of the foundation, which does not have a dedicated program team to lead the work, so an important condition was the presence of a partner with the capability to implement a program. NFF was well-suited to take on the role of project coordinator. With this critical piece in place, NFF and Irvine launched the California Pay for Success Initiative with an initial grant of $2.5 million in 2014 and the possibility for an additional $1.5 million of funding, should progress be made, in 2015.

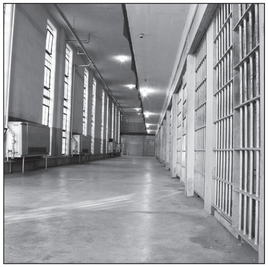
The goal of this initiative is to catalyze the development of PFS agreements in California. While there has been tremendous interest by impact investors in this model, few pay-for-success deals exist, and no such deal has tested this concept in California. The initiative will provide up to eight nonprofit and government leaders across the state, selected by NFF, with flexible funding and expert support to help them structure and close PFS agreements. While award decisions will likely prioritize projects that demonstrate the highest likelihood of arriving at signed PFS agreements within two years, projects in earlier stages of development will be eligible as well. The funding can support a variety of project needs, including cost-benefit analysis, data collection, and project management. In addition, the initiative will support peer learning so that project leaders can share and learn from their experiences. Finally, project leaders will have exposure to potential philanthropic investors, with the aim of reducing the time to bring deals to market.

Within two years of the grant awards, the initiative's goal is to have three executed PFS agreements. Don Howard, executive vice president of the James Irvine Foundation, acknowledged that this may be an audacious goal, but stressed the importance of testing the model, which he characterized as being at the intersection of several important innovative forces in the social sector, such as investing in prevention, scaling what works, impact investing, and achieving greater "bang for the buck" for public funding. He also pointed to the potential for multiplier effects. By providing support and learning opportunities to a set of PFS leaders, the initiative is designed to stimulate the creation of a stronger field of technical assistance, knowledge, and demonstration points for future projects. "We believe it's important to build the capacity of PFS leaders so that they can continue to shape this market when the initiative is over," Howard said.

Jessica LaBarbera, director at Nonprofit Finance Fund, expressed enthusiasm for the James Irvine Foundation's groundbreaking approach, and described it as a significant learning opportunity. She characterized the initiative as both an innovative way to think about funding PFS in a space where there is still so much infrastructure to be built, as well as a model for how to deliver resources rapidly and flexibly to support innovation more quickly than traditional grantmaking. PFS, she said, is where the foundation saw an opportunity to use its funding for something that would be "disruptive, scalable, and game-changing." With regard to advancing understanding of PFS, she highlighted the fact that it is still in the proof-of-concept stage. "If we don't see demonstrated progress after two to three years, we'll need to look at that very critically," LaBarbera added. "Valuable lessons may be gleaned that can inform the broader market."

Founded in 1937, the James Irvine Foundation strives to expand opportunity for the people of California to participate in a vibrant, successful and inclusive society. With $1.8 billion in assets, the Foundation made grants of $69 million in 2013.

Others suggest that even if it were desirable to wind down foundation support of the SIB market, this goal is unlikely to be fully achieved for many years to come. Mainstream impact investors may come to contribute perhaps 80 or 90 percent of the capital for future SIB projects, they believe, but there may always be a small but significant role for foundation capital. While philanthropic entities invested £5 million in the first SIB in the UK, future deals could perhaps use the same amount structured as credit enhancement to raise £100 million from mainstream impact investors.



FOUNDATIONS SUPPLY MUCH MORE THAN MONEY; THEY ALSO CONTRIBUTE LONG AND DEEP EXPERIENCE WITH TACKLING SOCIAL CHALLENGES IN NEW AND INNOVATIVE WAYS.

Moreover, since many interventions offer broad social benefits that may be difficult to monetize, it is possible to envision a future in which mainstream impact investors and foundations continue to co-fund some SIB transactions: Mainstream impact investors could fund the bulk of a SIB transaction, which may roughly correlate to the readily quantifiable benefits of the project, while foundations fund a smaller component of the transaction to support the project's difficult-to-quantify social welfare benefits. This arrangement would underline the core strength of the SIB model—its ability to facilitate multi-sector, multi-partner collaboration to generate both social and financial benefits.

As the SIB market learns and innovates from early-stage deals, SIBs will be poised to deliver future benefits as a "sustaining innovation"—technologies that improve the performance of an established product. They are the world's newest hybrid vehicle, created by the merger of existing components and holding meaningful promise for future progress. When Toyota introduced the Prius in 1997, it was the world's first commercially viable gas-electric hybrid car, and it proceeded to revolutionize the industry through its innovative mingling of two distinct power sources. Similarly, SIBs offer the potential to mingle public and private sectors; grantmakers and investors; local, state, and federal government officials; and commercial and philanthropic capital to create hybrid vehicles that are built upon a framework of true and lasting partnership in the pursuit of social progress.

Appendix I

List of Organizations Interviewed

Anonymous foundation

The Annie E. Casey Foundation

Bank of America Charitable Foundation

The Big Lottery Fund (UK)

Bloomberg Philanthropies

The California Endowment

The Clark Foundation

The Cleveland Foundation

The Duke Endowment

The Dunham Fund

The F.B. Heron Foundation

The George Gund Foundation

Global Impact Investing Network

The James Irvine Foundation

The Joyce Foundation

The Kresge Foundation

Laura and John Arnold Foundation

New Profit Inc.

Nonprofit Finance Fund

Omidyar Network

The Pershing Square Foundation

The Piton Foundation

Richard and Susan Smith Family Foundation

Robert Wood Johnson Foundation

The Robin Hood Foundation

The Rockefeller Foundation

Third Sector Capital Partners

The W.K. Kellogg Foundation

Appendix II

Resources on Social Impact Bonds

From the United States

Center for American Progress, Series on Social Impact Bonds. http://www.americanprogress.org/series/social-impact-bonds/view/

Federal Reserve Bank of San Francisco, "Pay for Success Financing," *Community Development Investment Review* (April 2013). http://www.frbsf.org/community-development/publications/community-development-investment-review/2013/april/pay-for-success-financing/

Godeke Consulting, "Building a Healthy & Sustainable Social Impact Bond Market: The Investor Landscape" (December 2012). http://www.rockefellerfoundation.org/blog/building-healthy-sustainable-social

McKinsey & Company, "From Potential to Action: Bringing Social Impact Bonds to the US" (May 2012). http://mckinseyonsociety.com/downloads/reports/Social-Innovation/McKinsey_Social_Impact_Bonds_Report.pdf

Nonprofit Finance Fund, Pay for Success Learning Hub. http://payforsuccess.org

Social Finance, Inc., "A New Tool for Scaling Impact: How Social Impact Bonds Can Mobilize Private Capital to Advance Social Good" (February 2012). http://socialfinanceus.org/sites/socialfinanceus.org/files/small.SocialFinanceWPSingleFINAL_0.pdf

From the United Kingdom

Social Finance Ltd, "A Technical Guide to Developing Social Impact Bonds" (January 2013). http://www.socialfinance.org.uk/resources/social-finance/technical-guide-developing-social-impact-bonds

UK Cabinet Office, Centre for Social Impact Bonds, The Social Impact Bond Knowledge Box. http://data.gov.uk/sib_knowledge_box/

About the Authors

Jane Hughes is the Director of Knowledge Management at Social Finance where she focuses on analyzing industry trends, enhancing organizational learning, and disseminating knowledge to our key audiences. She has inhabited both the financial world and social development world and is dedicated to bringing these forces together for the benefit of all stakeholders. Most recently, Jane was executive director of World Learning's master's degree program in sustainable development in Washington, D.C., where she created and taught a course on microfinance and impact investment. She spent 17 years as an international finance professor at Brandeis University's International Business School.

Prior to her academic career, Jane was a vice president at Manufacturers Hanover Trust Company in New York. Jane has consulted, lectured, and published widely in the fields of international banking and finance; business, government, and the global economy; and international development. She co-wrote a leading textbook on international banking, and is currently working on a second edition of *Separating Fools from Their Money: A History of American Financial Scandals* (first edition, 2007). Jane graduated magna cum laude from Princeton University with a degree in French literature; she also has a master's degree from Johns Hopkins University School of Advanced International Studies, and an MBA from New York University.

Jill Scherer is an Associate Director and Grants Manager for Social Finance where she oversees the organization's foundation deliverables and grant reporting. In addition, she plays a key role in the organization's fundraising efforts by researching and writing grant applications.

Prior to joining Social Finance, Jill conducted research on how innovative finance can drive community and international development. Most recently, she was a Senior Research Analyst with the Milken Institute, an economic and financial think tank in Los Angeles. She co-authored several reports in support of Milken's Financial Innovations Labs, roundtables designed to identify financial solutions to social, economic, and environmental challenges. Her reports spanned the topics of early childhood, health, and small business growth. Previously, she worked in the private sector at Charles River Associates, a business and economic consulting firm. Jill has a Master's Degree in Public Policy from the University of California, Berkeley and a B.A. in Economics from Wesleyan University.

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SOCIAL FINANCE, INC.

Founded in January 2011, Social Finance is a 501(c)(3) nonprofit organization that is dedicated to mobilizing investment capital to drive social progress. We believe that everyone deserves the opportunity to thrive, and that social innovation financing can play a catalytic role in creating these opportunities.

We are dedicated to designing public-private partnerships that tackle complex social challenges, such as crime, unemployment, education, and health. As a market intermediary, we structure these partnerships by aligning the unique interests of all stakeholders—service recipients and providers, government and investors—to create innovative financing solutions. This work reflects our commitment to driving social progress through a market-based approach, as well as our experience in the governmental, capital markets, social services, and philanthropic sectors.

Core to our work is the development of Social Impact Bonds (SIBs), which draw upon private capital to fund effective interventions designed to address the needs of underserved individuals. Social Impact Bonds have the potential to unlock a new and vast pool of investment capital to finance the expansion of prevention-based projects, while focusing on measurable outcomes and generating social and financial returns for investors.

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SOCIAL FINANCE

A TECHNICAL GUIDE TO DEVELOPING SOCIAL IMPACT BONDS

CONTENTS

"WE CANNOT GO ON ASSUMING THAT PUBLIC MONIES WILL BE SUFFICIENT TO RESOLVE OUR MANY DEMOGRAPHIC CHALLENGES."

Lord Michael Bichard, July 2012

PURPOSE

Social Finance is a not for profit organisation that brings together finance, social and governmental expertise to redesign public services. Where necessary we help to bring in social investors who can provide finance and take on delivery risks to enable the implementation of innovative new models.

Since late 2007 when we started to develop the Social Impact Bond (SIB) idea, we have worked with HM Treasury, Ministry of Justice, the Department for Communities and Local Government, Home Office, Department for Work and Pensions, Cabinet Office and a variety of local authorities to assess and create models in different issue areas.

This guide draws on our experience to date in exploring the feasibility of SIBs, particularly in the area of Children's Services. Social Finance worked with Essex County Council to develop and launch the first local authority-commissioned SIB in November 2012. The Essex SIB focuses on vulnerable adolescents at the edge of care or custody and funds intensive intervention in order to reduce the time they spend in care or custody and enable them to stay "safely" at home with their families if possible.

We use our work developing the Essex SIB as a case study. The guide aims to set out one approach to taking a SIB from proposal to the launch of a service funded through social investment. This guide is written to assist those developing SIBs to reach a stage where it would be possible to establish a contract between a public sector commissioner and investors, which in turn would offer a foundation on which to raise investment.

The thoughts included here represent Social Finance's experience to date in developing SIBs. We will learn more and refine this process on future projects. We hope to learn from others' approaches. This is a new and changing market and we hope this guide provides a useful template for developing approaches to shift more resource into prevention work. While this report focuses on Children Services, we believe there is potential for SIBs to offer solutions in other local authority services areas where there is potential for significant social impact.

Social Finance is committed to providing a range of support for those interested in developing SIB proposals. This could range from full engagement through a detailed feasibility study of a particular intervention or issue area to help with specific parts of the SIB development process (see below for further details of this process). We are aiming to provide a set of tools to help minimise the costs of developing these products and we hope that this guide – which is intended to be freely available – is a useful start point.

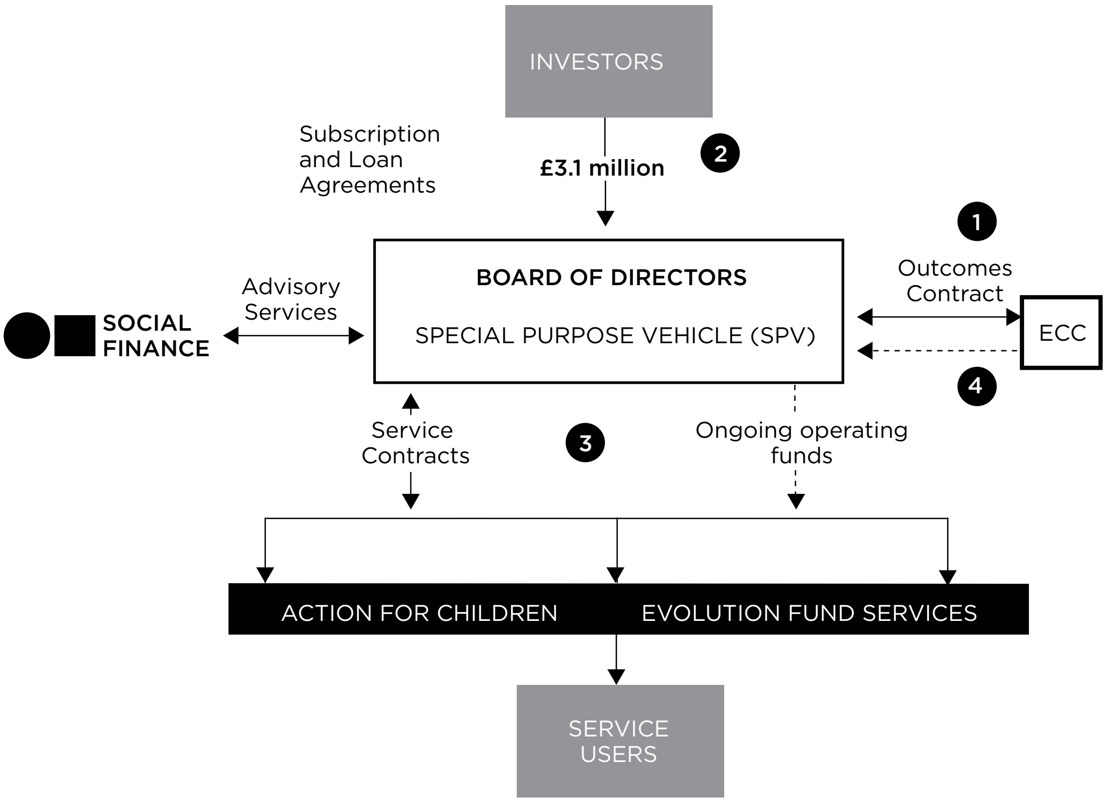
To discuss this report or to get in touch with a SIB enquiry please contact Tom Symons by telephone on 0203 586 8032 or by email at tom.symons@socialfinance.org.uk.

1 What is a Social Impact Bond?

A SIB is a contract with the public sector in which it commits to pay for improved social outcomes. On the basis of this contract, investment is raised from socially-motivated investors. This investment is used to pay for a range of interventions to improve social outcomes. If social outcomes improve, investors will receive payments from government. These payments repay the initial investment plus a financial return. The financial return is dependent on the degree to which outcomes improve.

The diagram below draws on the Essex SIB as an example to illustrate how a SIB can be structured.

Figure 1:



1. SPV and ECC enter Outcomes Contract
2. Investors fund SPV
3. Funds released to service providers according to Service Provider Agreement
4. ECC returns a % of savings from reduced cost of care placements

2 Social Impact Bond Objectives

The SIB approach – using an outcomes contract funded by social investment - is designed to access additional sources of finance focused on improving social outcomes. SIBs focus on funding preventative and early intervention programmes which tackle the underlying causes of specific social problems. Incentives are aligned across public sector commissioners, external investors and service providers, all of whom are acting to achieve a set of jointly agreed improved outcomes.

The main objectives of the SIB are to:

- Align public sector funding more directly with improved social outcomes;
- Increase the pool of capital available to fund prevention and early interventions;
- Enable a broad diversity of service providers to collaborate;
- Provide greater certainty over revenue streams for effective service providers; and
- Encourage a more rigorous approach to performance management including objective measurement of outcomes which contributes to building a broader evidence base for what works.

The first SIB was launched in September 2010 at Peterborough Prison. It funds rehabilitation services for short-sentence prisoners released from the prison, with the express aim of reducing reoffending post-release. At the publication date for this report, a total of thirteen SIBs have been launched in England, ranging from supporting young people to find work to helping rough sleepers off the streets.

SIBs and Children's Services

Children's Services teams across the country address a range of needs when working to improve the lives of children in their areas. Many of the activities carried out by children's services are statutory. Others are more preventative in nature and aim to address underlying needs before they escalate into crisis.

Social Finance has, to date, developed two SIB models designed to fund intensive and targeted interventions to support adolescents in or at risk of entering care. The objective is to demonstrate that investing resource into preventative work can deliver improved social outcomes at the same time as relieving cost pressure on already strained acute budgets.

There will undoubtedly be a range of areas of social need to which the SIB approach could be applied. The models that we have developed to date are merely a starting point. We hope that this guide serves to illustrate to commissioners, service providers and others one approach to developing SIBs.

3 The Social Impact Bond Development Process

Social Impact Bonds will not apply in all circumstances. In many areas, traditional funding streams will remain the most appropriate. To determine whether a SIB could apply to tackling a specific social problem, a number of factors must be considered. We set out below the various stages of the development process:

ASSESS THE SERVICE AREA THAT NEEDS RESHAPING

Discussion as to whether an outcomes contract (which could be a SIB) or other options is the best way to commission services.

OUTPUT

Agreement to explore social investment options as part of the service redesign

DEFINE THE SOCIAL ISSUES

Data analysis to understand population trends and cost pressures.

Stakeholder engagement to understand strategic objectives.

OUTPUT

Defined target population.

Engaged commissioner(s).

DEFINE OUTCOME METRIC(S)

Research on desired outcomes for target population.

Assessment of measurement attribution options.

OUTPUT

Indicative outcome metrics to ensure success of intervention(s)

DEFINE INTERVENTION(S)

Needs assessment of target population.

Research on interventions to meet these needs.

OUTPUT

Intervention(s) to be funded by SIB.

STAKEHOLDER ENGAGEMENT

OUTPUT

Commissioner(s), Service Provider(s) and Investor(s) satisfied with project and eventual outcome.

VALUE-FOR-MONEY CASE

Financial model to assess potential savings as a result of the intervention(s)

OUTPUT

Outline Business Case to be approved by commissioner(s).

PROGRAMME DESIGN

Detailed operating plan and due diligence on potential service providers for SIB-funded service.

Finalisation of outcomes measurement and payment framework

OUTPUT

Term(s) sheet to form the basis of a SIB contract.

Final Business Case.

PROCUREMENT

For the SIB-funded service

OUTPUT

Provider for SIB-funded service

CONTRACTING

Develop SIB contract

Government arrangements with SIB counterparty.

Marketing to investors and securing commitments for investment required to pay for services.

Service providers commissioned to deliver services to target group

OUTPUT

Fully-funded services.

Move forward to implementation and delivery of services.

This guide will aim to explain this process in more detail with reference to the SIB development work carried out by Social Finance looking at funding interventions for children on the edge of care.

In practice, this process is not linear and is dependent on satisfactory answers to a series of questions; for example, do the potential cost savings cover the returns to investors (return of initial investment and a return for the risk taken in funding the project) while leaving sufficient savings for the commissioner(s)? These questions will be dealt with in more detail in the ensuing sections of this guide.

IS SOCIAL INVESTMENT AN APPROPRIATE WAY TO PAY FOR IMPROVEMENTS TO SERVICE PROVISION FOR A PARTICULAR GROUP OF PEOPLE?

4 Assessing the service area that needs reshaping

Social Impact Bonds provide investment to address social problems and look to fund preventative interventions. As such, they present an opportunity to provide support to reduce the strain on acute services.

It should be noted that social investment is one form of finance available to pay for programmes that generate positive social outcomes. In many cases, a SIB may not be relevant:

- There will be many services where it is still more appropriate to fund on the basis of activity rather than outcomes. In particular, in some services there may be few opportunities or benefits associated with transferring risk to an independent provider or investors. For example, if the way in which the service is provided is heavily prescribed by statutory obligations, such as policing, there may be little scope for innovation by paying on the basis of outcomes.
- It may also be difficult to transfer risk because it is not possible to write an effective outcomes-based contract, for instance it is hard to ensure that any change in outcomes is due to the impact of the new programme rather than external factors.
- Finally, there will be instances where it is almost certain that the desired results will be achieved by paying for the activity. To delay payment until outcomes are verified would simply incur costs associated with raising working capital.

If commissioners are looking to shift contracting to the basis of outcomes for the primary purpose of encouraging better performance within an existing approach, it is probably not necessary to bring in funding from social investors. The existing providers should be able to cover service costs through their own reserves. Risk transfer will typically be lower and service providers will feel more comfortable taking these risks themselves. In these instances, a Social Impact Bond is not required. For example, if a commissioner of a back-office service is looking to introduce an element of payment by outcomes, there are likely to be a number of large, well-capitalised commercial providers who would be interested in providing the service and will be able to cover the risk from their own reserves. It will not be necessary to consider the needs of attracting investors, particularly social investors, in procuring the service.

In practice, there will be a spectrum of outcomes-based commissioning approaches where investors bear more or less of the risks involved. There is no absolute point at which a Social Impact Bond is needed and other types of outcomes-based contracts are inappropriate. The issue for commissioners is the extent to which it is important to stimulate better delivery by paying on the basis of outcomes and the likelihood that external investors will be required to share the risk of achieving these outcomes.

It should also be pointed out that, in our initial experience in developing the SIB market, social investors are looking to enable the capacity of the voluntary and community sector to deliver interventions, rather than pay for services to be carried out in-house by government commissioners or by large for profit providers.

For further details please see: *Commissioning Social Impact Bonds, Social Finance, November 2011.*

5 Defining the social issue

In Box 1 below, we set out our working hypothesis for a SIB focused on reducing or preventing time spent in care by adolescents experiencing behavioural problems or family breakdown. Ultimately, the SIB-funded intervention will be based on trying to improve outcomes for this group of people.

Box 1 – Vulnerable Children and Young People: Working SIB Hypothesis

There are significant numbers of adolescents in and at the edge of the care system due to behavioural problems or family breakdown. Typically, over 30% of looked after children are in the adolescent age range.

For many adolescents entering care there is a strong probability of staying in care long-term.[1]

Outcomes for looked after children are significantly worse than for children in the population as a whole. For example, **looked after children's level of GCSE attainment is five times worse than for children overall.**

The financial costs to local authorities of young people entering and remaining in the care system are high. **The estimated expenditure on looked after children is more than £2 billion per year in England**.[2]

The direct cost of placement for a looked after child is, on average, £40k a year. Placement costs range from £25k to £180k per child per year, ranging from foster care to specialist residential care.

There are interventions which address the needs of such vulnerable young people and those of their parents, stabilising the situation and enabling the family to remain together. Such interventions range from those of a practical nature to more therapeutic services.

A Social Impact Bond could raise investment to fund such interventions intended to reduce preventable family breakdowns and the number of young people entering care. A SIB could also fund support for those who have recently become looked after, aiming to swiftly reunite them with their families, where measures are in place to address the underlying needs of the young person and their family.

A lead outcome indicator may be one linked to reducing or preventing time spent in care which in turn can be linked to "cashable savings" and improved social outcomes. In some cases savings might not be immediately cashable but there may be a commissioner willing to pay for improved social outcomes. This would need to be balanced by a basket of indicators to reflect wellbeing of the child.

1 Sinclair, I. *et al.* 2007. *The Pursuit of Permanence: A Study of the English Child Care System.* The research shows that the chance of leaving care is greatest in the first 50 days of the child being in care. After that, the rate of leaving decreases rapidly.

2 The NHS Information Centre. 2008. *Personal Social Services Expenditure and Unit Costs England*.

In developing a SIB, the activities required to define the social need fall into two main areas:

Stakeholder engagement

A Social Impact Bond requires an engaged commissioner (or group of commissioners) open to outcomes-based contracting, where payments are made if agreed social outcomes are achieved. It is important to work in conjunction with an engaged commissioner, through access to data and discussion, in order to develop outcome metrics and target population definitions. Within a local authority, engagement might come initially from the service lead, corporate centre, finance or elected member. It is important that if feasibility work is to be undertaken, that this range of stakeholders is consulted through the process and is supportive of the conclusion.

It is recognised that there are often a range of strategic priorities that commissioners are looking to tackle and a SIB approach is potentially an option for tackling one or more of those issues.

IS THERE AN ENGAGED COMMISSIONER COMMITTED TO TACKLING THE SOCIAL NEED FOR A DEFINED TARGET GROUP?

Data analysis

Illustration of social need: adolescents between the ages 10-15 make up the largest age group entering the care system. This group is more likely than other age groups to remain in care and not return home.[3] Their needs are often complex and could involve significant breakdown in family relationships. Those who stay in care long term often experience poorer outcomes in health and education.

On the basis of the stated social need, it is necessary to clearly define the target population. It is this group for whom interventions will be funded and outcomes improved. There must be clear criteria against which the target population can be identified and a process through which referrals can be made into the SIB-funded interventions.

Illustration of target population and referral point: adolescents aged 10–15 years old, with behavioural problems, who are referred to the Children's Resource Panel of a Local Authority. Examples of eligibility criteria or risk factors presented by such adolescents might include: siblings already looked after, family subject to other services, prior history of being looked after, at risk or record of youth offending.

If the definition is not focused enough the interventions may be too diffuse to have a significant impact on the target outcome. If the definition is too narrow, the target population may not be sufficient to require a dedicated service.

Social Finance would look to analyse local information to understand the major trends, including:

- Flows into care (by age of child, type of referral, reason for referral);
- Flow into / out of different care placements;
- Average length of time spent in care across childhood for target population; and
- Costs to government services for these placements.

Output

A defined group of children (e.g. 10-15 year olds at risk of entering care) that a) are seen as a strategic priority by the commissioner, b) have historically had bad outcomes and c) have raised significant costs for the commissioner.

This target population will form the basis of the overall SIB contract that is being developed.

6 Define the outcome metric(s)

The outcome metrics form the foundation of the SIB contract between the public sector and investors. All stakeholders need to trust that there is an objective mechanism for assessing and agreeing the degree to which social outcomes have been achieved.

The most important criteria for any outcome metric is whether it incentivises a service that ultimately improves outcomes for those who use it. In addition, when making the value-for-money argument (see below), it is helpful to link such a metric to cashable savings on the part of the public sector commissioner. Immediate cashable savings may not always be forthcoming but there may be intermediate indicators that commissioners are willing to pay for if there is a strong link to the longer term outcome which generates savings. Alternatively, there may be funders willing to pay for outcomes which carry significant social value even in the absence of cashable savings.

The key is to identify an outcome metric which is measurable and objective. There must be a willing funder to pay if outcomes are delivered. Whether or not suitable metrics can be identified is a key determinant of whether or not a SIB is the appropriate instrument for addressing an identified social need. Care should be taken to ensure that the selected metric does not create perverse incentives.

Alongside the identification of outcome metrics, a system of measurement will need to be developed such that the degree of improvement in outcomes achieved can be identified.

Developing appropriate outcome metric(s)

Illustration of outcome metrics:

The outcome metrics against which success could be assessed would likely include a combination of objective and subjective metrics. Some but not all need to be linked to investor payments.

CAN A ROBUST OUTCOME METRIC WHICH GENERATES THE RIGHT INCENTIVES FOR THE VARIOUS STAKEHOLDERS INVOLVED BE DEVELOPED?

The Edge of Care SIB in Essex collects a basket of outcome metrics:

- Care placement days saved
- Educational engagement
- Offending
- Emotional wellbeing

The basket of metrics are included to guard against perverse incentives – to ensure that interventions do not prevent care entry if that is the best option for a particular young person.

A key consideration when identifying an outcome metric is whether or not the right incentives are generated for the various stakeholders involved. One example of this is deciding between a binary and a frequency outcome metric. An illustration of this consideration in the context of developing Social Impact Bonds for adolescents at the edge of care is provided below.

Binary Outcome Metric: A binary outcome metric might be defined as an individual who does not enter care. This is a clear measurement. Even if the young person spends a single day in care, this will be recorded as a failed outcome and therefore no payment will be liable. While many see binary metrics as the simple, clear-cut option, there is a risk that this approach can lead to perverse incentives. It may be, for example, that a short spell in care is the best solution for the young person and his or her family to provide respite from a highly charged situation. Following this brief spell the family might be reunited with a programme of intensive support which addresses some of the underlying issues and results in sustained positive outcomes. Under a binary metric, however, this example would be recorded as a failed outcome and no payment would be due. In this case, the design of the outcome metrics does not promote behaviour in the best interests of the client. Binary metrics may also incentivise service providers to cherry-pick the less complex cases where the young people have the lowest chance of spending time in care. While acknowledging the potential downsides of a binary approach, it is a model that is being applied and has the advantage of being simple to implement.

Frequency Outcome Metric: The desired outcome could be a reduction in number of days spent in care by the target group. This approach encourages service providers to work with the entire target population. However it is harder to measure since it is relative to a benchmark (what is the expected number of care days in the absence of the intervention?) and that benchmark needs to be established. Any reduction in time spent in care as compared to what would have happened without the intervention, is recorded as a positive outcome and payment based on the care placement days saved becomes due.

Establishing a measurement framework

The measurement framework sets a benchmark against which SIB outcomes would be determined. The benchmark reflects outcomes in the absence of SIB interventions. Once a benchmark is established then outcomes achieved by the target group can be compared and the difference measured. This enables attribution of benefit generated by the SIB-funded interventions to be calculated. Three common ways of generating a benchmark, one using historical data or contemporaneous data, are described below.

1. Historical benchmarks for an equivalent population

Historical data for a similar population of young people can be analysed to determine the likely outcomes for the target population. In the case of adolescents at the edge of care, a benchmark could be generated by reviewing historical case files of children previously referred to the resources panel over a selected time period. Individual characteristics such as age, needs, legal status, mental health status and family characteristics such as parental needs and vulnerabilities are reviewed. Those adolescents who would have been suitable for the proposed SIB-funded intervention (were it available at the time), are selected into the comparison group. The benchmark, for instance aggregate number of days spent in care by the comparison group over a specified period post referral, is then generated. Outcomes of those receiving SIB interventions can then be measured against this benchmark.

One advantage of using historical benchmarks is that this methodology does not exclude individuals in the comparison group from receiving SIB interventions. Historical benchmarks are best when there is a reasonably stable population with a consistent level of outcomes (or predictable trend in outcomes) over a number of years. They also work best for outcomes that are not significantly affected by broader socio-economic trends and external factors outside of the control of service providers.

2. Pre- and post- intervention measurements for target group

This approach to measurement is sometimes referred to as 'distance travelled'. It measures outcomes for the individuals in the target population prior to the intervention start date and at a point after they have received the intervention service. This approach is often used when data is collected through questionnaires such as the Strengths and Difficulties Questionnaire (SDQ), which measures emotional well-being. The questionnaires are completed by participants at the beginning of their engagement with the proposed service and after leaving the service. Any changes can then be measured. While this approach is quite straightforward to administer and there are many standard questionnaires available, it does not measure improvement relative to what would have happened anyway – how the target group would have fared had they not received the proposed service.

3. Live baseline or control group

This approach compares the outcomes achieved by the target group against a contemporaneous control group that is monitored during the period of intervention. The control group seeks to mirror the treatment group in characteristics and, where possible, be subject to the same socioeconomic context. The only difference is that the control group does not receive the proposed service that the treatment group benefits from. For example, in the national research trial jointly funded by the Department for Education, Department of Health and Youth Justice Board to evaluate the benefit of Multisystemic Therapy (MST) in ten trial sites in England, adolescents suitable for the MST service are randomised into (or out of) the service. The benefits of a live control group is that changing external factors are controlled, since both the control group and treatment group will be experiencing the same changes (e.g. socio-economic trends), which means that the difference in outcomes measured between the two groups should capture the effect of the SIB-funded intervention and not the effects of external factors. On the other hand, this methodology means that those randomised out of the intervention will not be able to receive the SIB-funded service for the length of the outcomes tracking period. In addition, twice as many referrals will need to be generated with respect to the new service, since half of those referrals will be randomised out – in particular, if the new SIB-funded service has large fixed costs, then generating enough referrals will be essential to sustaining the service.

Outcome Valuation

The outcome valuation for a SIB is a combination of the social value that a commissioner will pay for and the average public sector cost saving resulting from an improvement in the outcome. In its simplest form, the outcome value is narrowly defined in terms of the cost savings accruing to specific public sector budgets. With the introduction of co-commissioning funds such as the Cabinet Office's Social Outcomes Fund, it is likely to become more practical to implement SIBs where savings accrue to more than one commissioner's budget.

Illustration of outcome valuation

Local authority social care cost savings due to a reduction in care placement costs. This potentially could be combined with other sources of savings where the relevant outcomes were achieved as a direct impact of the SIB-funded interventions. Some examples include:

- a reduction in local youth offending costs if the SIB-funded interventions reduce offending behaviour amongst adolescents comprised in the target population. Savings might accrue to the Youth Justice Board.
- a reduction in costs of places at Pupil Referral Units if school exclusions were reduced amongst the target population. Savings might accrue to Department for Education and local schools.

The calculation set out in **Figure 2** below illustrates how one might start to value the outcome of preventing a young person from entering care.

Quantification of broader social outcomes (e.g. safer communities due to reduced antisocial

Figure 2: Illustrative Outcome Valuation – average placement cost through a young person's care journey (Note: these numbers are purely illustrative)

TYPE OF PLACEMENT	PROBABILITY OF ADMISSION INTO PLACEMENT (Column A)	AVERAGE COST OF CARE PER WEEK (Column B)	ESTIMATED AVERAGE LENGTH OF STAY IN CARE FOR 10–15 YR OLDS (Column C)
Fostered (In-house)	**40%**	**£400**	104 weeks (based on the estimation that individuals stay in care for 2 years)
Fostered (external)	**20%**	**£900**	
Residential	**20%**	**£3,500**	
Placed with parents	**3%**	**£200**	
Kinship	**15%**	**£200**	
Secure accommodation	**1%**	**£5,000**	
Other	**2%**	**£200**	

Calculation:
Step 1 – Column A x Column B = Average costs of placement per person per week
Step 2 – Average costs of placement per person per week x length of stay in care (Column C)

Average placement cost throughout individual's care journey = £117,520
(excluding social justice and legal costs)

behaviour, improved school attendance leading to better qualifications and reduced probability of becoming NEET) reflect important social benefits, but do not release cash from public sector budgets that could be used to make outcomes-based payments to investors in a realistic time frame.

Output

An outcome metric (or number of outcome metrics) that fulfils the following criteria:

a) Aims to improve outcomes for the target population and minimises perverse incentives

b) Can be objectively measured/verified from a reliable data source and includes the setting of an appropriate benchmark from which to judge the success of the programme

c) Reflects the current cost to the SIB commissioner(s) within the proposed outcome tariff

7 Defining the intervention(s)

We are looking to develop SIBs that tackle the underlying needs of vulnerable children and young people. Given that these individuals often come from a family environment in which multiple risk factors are present, we recognise that there may be a need to bring together a suite of interventions that are tailored to address the needs of both the young person and his/her family members, and which reflect the local circumstances in which the programme operates.

A first step is to identify the underlying needs of the target group, which the selected interventions will tackle. Once the profile of needs is understood an intervention programme can be developed. To do this, there needs to be a review of both national and local service providers to identify where complementary interventions could best meet the needs of the target population and achieve the desired outcome. The SIB funding structure encourages all service providers to work collaboratively towards achieving the target outcome.

To determine the feasibility of the intervention programme for SIB funding it is necessary to establish the impact the programme is likely to have on the target outcome. This is dependent on two considerations:

- The degree to which interventions are well understood and can be evidenced.
  - Illustration of intervention development: Social Finance has undertaken a review of the interventions relevant to the defined target group. This involves investigating qualitative and quantitative evaluations, interviewing service provider staff members and analysing how these interventions meet the needs of the target group and improve their outcomes.
- Whether there is a gap or scarcity of service provision to the target population such that SIB investment is likely to lead to a significant change in the target outcome.
  - Illustration of intervention development: if there were little existing targeted support for families of young people who are at risk of entering or who have entered the care system, then investment in this area is likely to yield higher social returns and consequently financial returns to investors.

Developing the Operating Model & Intervention Costs

It is necessary to have a robust understanding of the total programme delivery costs, including infrastructure and overhead costs particularly where there is a need for more than one service provider to deliver. We recommend supplementing a review of operational budgets (when available) with a review of local and national service providers in order to understand the likely costs involved. The development of an indicative budget for the proposed suite of services will determine the level of funding that will need to be raised from investors through the SIB.

It is important at the feasibility stage to consider the practical implications of how the SIB can operate. Engagement with a commissioner is required to understand how the portfolio of SIB interventions could sit alongside the local authority's "business as usual" processes.

Illustration of Operating Model

Discussions with the local authority commissioner may result in an agreement that referral to the SIB occurs at a point when cases were taken to review at the Children's Resource Panel. An agreed set of eligibility criteria would be required such that social workers reviewing the cases could easily identify those who should be considered for the SIB intervention. The Operating Model needs to consider how the SIB-funded service interacts with the Social Care team and the services they deliver. In particular it is important that the statutory duty of care to families required by local authorities is upheld.

There would need to be a plan in place for systematic monitoring of performance and collection of data through a case-management system dedicated to the SIB. A system of governance would need to be outlined for the SIB.

Output

A draft operating model detailing the service(s) that would be paid for by SIB investors, including a detailed articulation of how these services would meet the needs of the target population, interact with existing local authority provision and governance structures and what would be the indicative costs to deliver the programme.

8 Assessing the value-for-money case

As mentioned earlier in this guide, for a SIB to be feasible there has to be a commissioner (or group of commissioners) willing to commit to pay for outcomes if the service is successful. In Social Finance's development work to date, the decision by commissioners to proceed with this has been made with references to the following issues:

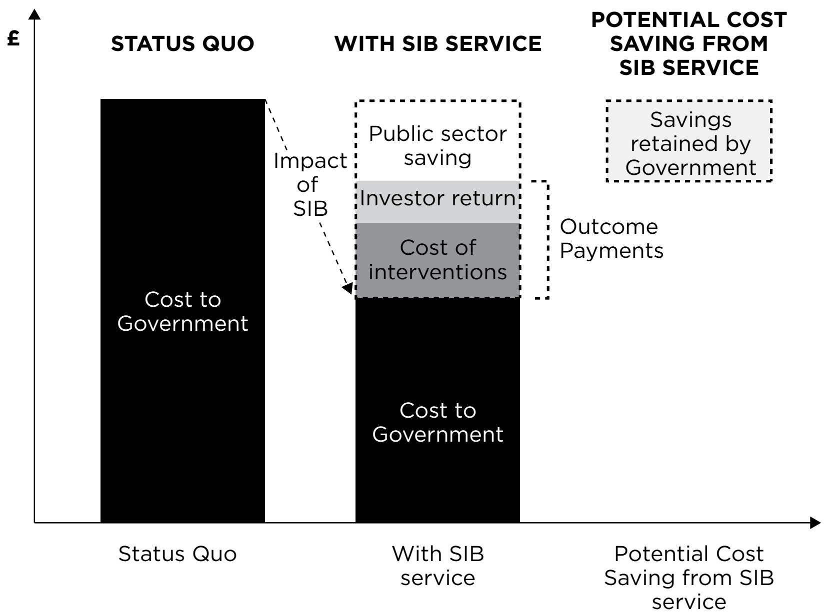
1. **Delivering cashable resource savings**
   A SIB helps a commissioner to avoid paying for failure as payments will be made if – and only if – a service meets its designated outcome metrics.
2. **Financing innovation**
   In the face of budgetary constraints, it could be difficult to test programmes that commissioners believe may work but currently have a small but growing evidence base. A SIB allows a commissioner to transfer implementation risk to the investors who, if the service fails to achieve the specified outcome metrics, will not receive any payments. Ultimately a fair risk share is preferable – a programme that has the potential to work but with enough uncertainty to prompt a commissioner to pay for the service on an outcome basis.

In the context of Children's Services, it is recognised that many of the current services provided are expensive. If better outcomes can be achieved at lower costs through a new set of services funded by a SIB, this may fulfil both of the criteria mentioned above.

The SIB Financial Model

A financial model is at the heart of the value-for-money case. It aims to tie together the social impact and funding flows. It reflects the economics of the SIB and the potential for the proposed interventions to achieve cost savings. It estimates the costs of interventions, overheads and other fixed costs which together determine the level of investment requirement over the life of the SIB. Set against this will be the share of the cost savings agreed by the commissioner to be distributed to investors should a sufficient improvement in outcomes be achieved.

This value-for-money calculation can be summarised as follows:



DOES THE FINANCIAL MODEL GENERATE SAVINGS TO THE LOCAL AUTHORITY AND A RETURN TO INVESTORS IN AN ACCEPTABLE TIME FRAME?

The financial model requires consideration of the following factors:

- Current costs to government of a particular target population
- Costs of a proposed SIB intervention
- Estimated impact of proposed intervention
- Potential cost savings to commissioner(s) – as shown above
- Estimate of investor returns

SIBs work when the costs of achieving the target outcome (intervention costs plus overheads and fixed costs) are substantially lower than the level of the resulting public sector savings (outcome value). This is essential to developing a financially viable investment proposition on which to raise capital. It is important for the commissioner to consider how the savings they are generating will be translated into payments to investors. In the example of the Essex SIB, many of the current care placements are spot-purchased by the local authority so any reduction in the number of days spent in care are immediately cashable.

A reasonable time horizon for the investment is critical. Investors would prefer to see a SIB that matures within a time horizon of around five years. Therefore there needs to be a tight timescale between intervention, measurement of impact and payment on outcomes achieved. This is a consideration particularly in examples such as early years intervention (0–5 year olds). If the outcome metric is educational attainment, but it is necessary to wait

11 years (age 5 to 16 years old) to measure GCSE results for the target population, this is not likely to make for a feasible SIB, unless intermediate or proxy outcomes are available against which payments can be made.

The focus on adolescents (aged 11–15 years old) provides a relatively compact time frame over which to measure outcomes. For this age group, research shows that if a young person remains looked after for more than a short time period (e.g. three months), the likelihood of remaining looked after on a long-term basis increases. Outcomes for the young person become much worse with long-term care. Therefore one approach could be to measure placement-related outcomes at 6 or 12 months post-intervention.

A further consideration is the time it takes to generate outcome payments. The earlier the commissioner is able to pay money back to investors, the lower the "cost of capital" investors will require. If investors receive early payments, they may be willing to "recycle" those payments into paying for costs of intervention during the remaining term of the programme. This reduces the upfront capital requirement which in turn reduces the "cost of capital". This will improve the value-for-money case to commissioners.

Investment raising process

Ultimately, this development process is aiming to provide a new service, paid for by additional money, that improves outcomes for service users. This money is provided by social investors, so-called because they want their investment to do two things: enable positive, measurable social impact and generate a financial return.

A SIB is a risky investment because, in its purest sense, investors stand to lose all of their money if outcomes are not achieved. Social investors are taking this risk because they are keen to enable new and effective services that deliver outcomes. As a result, they have a stake in the intervention achieving a positive impact on those who use it.

Therefore, it is recommended that the party coordinating the investment-raising process involves investors in the development of a SIB, likely prior to an Outline Business Case being signed off by a commissioner. This could involve early-stage discussion to gauge interest in a particular social issue area and ways of measuring success (outcome metrics, measurement framework – described above).

It is worth noting that the agent who coordinates this process will need to be regulated by the Financial Services Authority for this activity.

Output

The financial model would ultimately feed into a business case that synthesised the development work thus far:

- The social issue that the SIB-funded service is looking to tackle;
- The group of people that the service will target and potential level of referral flows;
- The outcome metrics by which the service will measure its success;
- The proposed interventions that make up the service offering; and
- The estimated savings to the commissioner if the service was successful.

This is a crucial decision point in the development of a SIB – an in-principle commitment from a commissioner to pay for outcomes. Following this approval, the design process begins in more detail.

9 Programme design

Following the approval of the SIB business case, the next phase involves more detailed consideration of the operating plan and payment terms that will form the basis of the SIB contract.

SIB Operating Plan

This operating plan will build out from initial recommendations made in the value-for-money case to a detailed plan that takes into account the following:

Caseload assumptions

By putting together a more detailed estimate of the number of expected users for a SIB-funded service, a more detailed operating plan can be put in place. Points to consider include:

- Measurement of current (baseline) outcomes prior to the start of service delivery. The SIB-funded service will ultimately be measured (and paid for success) against these baselines (see example below)
- Initial set-up costs prior to the formal start of service delivery
- A closing measurement period between the end of service delivery and the measurement of the final results of the programme

A SIB Operating Plan would need to factor in costs for dealing with all of these elements of the programme.

Illustration of Operating Plan: the lead in time required for initial contract set-up is dependent partly on the measurement framework chosen (see Section 2). If a live baseline – measuring the outcomes for those who would have been eligible for the intervention, starting prior to implementation and continuing during the period of the intervention – is used, there will be additional measurement costs incurred (e.g. measuring the number of days spent in care by adolescents aged 11 to 15).

Fit with existing local services

It is crucial that any additional service funded by a SIB fits well into the existing service landscape. Consideration must be given to issues such as the local authority's statutory duty of care to vulnerable adults or children. The operating plan would need to ensure that the referral route for those eligible for a SIB-funded service was agreed with the commissioner.

Service delivery partners

The service provider is an essential part of the SIB picture, without whom the programme will not help to improve outcomes for the target population. Given that investors will be funding the work of a social sector provider (or group of providers), the choice of organisation is crucial.

Due diligence on potential providers is crucial to help investors understand the risk (i.e. potential for successful outcomes to be achieved). This process will include a review of an organisation's:

- Track record – evidence of measurable success with the proposed target population and intervention approach
- Delivery capacity – including the scale of services an organisation is able to deliver and its local relationships in the SIB service area
- Financial viability – including an assessment of the organisation's balance sheet and ability to deliver the contract as a going concern. A review of its proposed operating budget should be undertaken and costs benchmarked to ensure value-for-money.

Illustration of Service Delivery Partner selection: For the Essex SIB, Social Finance ran an open selection process which started with a call for expressions of interest from voluntary sector service providers who were geared up to deliver evidence-based programmes. Providers were judged on a range of criteria including their ability to operate in Essex and to implement evidence-based programmes to help children reunite with their families and reduce their time in care. Service providers are selected based on a good track record of providing such services in the UK.

Performance management

Performance management involves working with service providers to enable them to measure effectively and deliver outcomes. In our experience to date, social investors seek performance management to improve the chances of successful delivery of outcomes. The performance management function enables:

- Strengthening of the participating delivery organisations through management support, sharing operational learning and best practices;
- Enhancing the impact and social value by analysing data to understand evolving profiles of service user needs and programme efficacy and using this to change and improve service delivery;
- Tracking and reporting of the social outcomes to enable broader learning about what works; and
- Improving investor confidence.

Illustration of performance management approach: typically a SIB will incorporate a Project Director or Performance Manager who spends time weekly on the ground in the locality where services are being delivered. The Performance Manager is not involved in service delivery but is a resource to support the service delivery partner in managing stakeholder relationships, linking into the local community, and maintaining high visibility and awareness of the service locally in order to generate consistently healthy volumes of referrals to the SIB-funded service.

The Performance Manager can be used as a troubleshooter to solve problems and will regularly analyse the data to understand what is going well and where improvements could be made. If there are multiple service delivery partners in place, the role of the Performance Manager will be more involved in ensuring productive collaboration between partners and a coherent package of provision to service users. Where there is a single service provider, the job of the Performance Manager may be less resource intensive but remains a critical resource to ensure that the programme is on track to deliver improved social outcomes.

SIB Payment Mechanism

The payment mechanism aims to describe in detail how the success of an intervention will be measured, sets a tariff for each successful outcome and indicates when these tariffs are due to investors. Therefore, it is important to provide clarity in the following areas:

Outcome metrics to measure the success of the intervention

This will encompass the desired and anticipated results of the SIB-funded service(s) and will be applicable to proposed intervention and related Outcome Payments. This involves taking the initial metrics proposed in Section 2 (above) and finalising the detail of how they will be measured in practice; for example, what would the data source be for each metric to be measured against?

Tariffs to be paid when success is achieved

The level of such payments is determined by the degree of success expected. Commissioners are liable to pay such outcome payments.

Illustration of outcome tariff calculation: the value-for-money case (Section 4 above) would give an indication of the potential cost savings accruing to the commissioner(s) if a SIB-funded intervention is successful. The tariff would aim to reflect an appropriate sharing of these savings between the commissioner and the investor. This share needs to be agreed on by both parties prior to the confirmation of an outcome tariff.

Timing of payments to investors

The timing of payment will depend on how the outcomes are measured. If individual outcomes are measured and paid for based on an individual's performance (e.g. the Work Programme), payments could be received as outcomes are obtained, on a frequent basis through the programme.

However, if payments are made based on the performance of a cohort of people (e.g. the Peterborough Social Impact Bond), they may be paid following the completion of the service delivery and measurement period, which requires investors to wait longer before being paid.

Investment Raising process

Once a robust financial model and proposed operating plan is agreed with the commissioner, the process of raising investment can commence. Discussions with investors set out both the case for social change and accompanying financial case. The aim of these conversations is to secure "in-principle" commitments (i.e. a non-binding commitment to invest depending on the ultimate outcome of the commissioner's decision and approval process).

These commitments will allow the proposal to move towards contract negotiations with some comfort that there is real appetite from investors to support it. This process will ultimately be completed on contract signing (see Section 7 below).

Output

A term sheet that summarises the main elements of the SIB contract. This contract is described in more detail in Section 7.

IO Procurement

It is highly likely that public sector commissioners will need to launch a procurement process in order to select either the service provider or the intermediary who brings together service provision and funding. In many cases a Part B procurement process is sufficient.

There are different structures through which social investment can be channelled and the counter party to the commissioner will vary accordingly:

Direct contract with the service provider: the commissioner could seek service providers with which they contract directly. The service provider may have a sufficiently strong balance sheet itself to self-fund the upfront working capital requirement. Alternatively, the service provider might need to seek investment support from a group of social investors and together bid into the procurement process. Commissioners may be attracted to the simplicity of contracting directly with the service provider. However where multiple service providers are involved this becomes more cumbersome.

Contract with a Special Purpose Vehicle (SPV): the commissioner might prefer to contract with a SPV set up specifically to deliver the SIB programme. Investors sometimes prefer this structure since the company that is set up as the SPV is the entity into which they invest. Therefore investors have ownership of the entity. The SPV can then contract with their selected service provider(s). If for any reason, during the term of the SIB contract, the service provider consistently underperforms, investors can replace the service provider.

Illustration of procurement process: Typically a Part B approach to procurement has been undertaken for SIBs to date. An element of dialogue has been helpful in allowing the detailed operational and financial plans to be developed in partnership with the commissioner, intermediary, service providers and investors.

For further information, we would recommend the following report: *Commissioning Social Impact Bonds, Social Finance, November 2011 (available on the Social Finance website)*.

Output:

A social investment-backed provider (or group of providers) to deliver the SIB outcomes contract.

II Contracting

This section aims to cover two main areas: the development of the SIB outcomes contract and the principles behind the SIB governance structure. We intend to give an indication of how we have approached the contracting process but recognise that as the SIB market develops, these structures are likely to change.

Outcomes Contract

The SIB will be based on a contract between the local authorities or other commissioners and the SIB Investors or service provider. The definitions below provide an indicative guide to some of the key contract clauses and possible governance structures.

The diagram in the Introduction of this guide illustrates the various contracting parties. The outcomes contract sits on top of the suite of contracts with service providers. The public sector commissioner and either the investor group or service provider are the contract counterparties (depending on the approach taken).

The outcomes contract may be developed by the commissioner and issued to providers and investors during the procurement process or it may be a more collaborative document which evolves from dialogue during the procurement process.

Contract Clause: Key Terms	Definition
Objective	Sets out the objectives and broad mechanics of the SIB investment.
Investment Amount	Amount of total "commitments" undertaken by investors
Commitment Period	Capital is called from investors during this period to finance the intervention and discharge the related intervention costs. This is expected to be between three and five years.
Term	Limited period of time within which capital may be returned to investors. This time period will extend beyond the Commitment Period (depending on term of intervention programme and length of tracking period for outcomes).
Intervention	Describes the nature of services to be funded in order to achieve Success Metrics. In conjunction with this, the social investment intermediary: • Establishes strategy for selecting Service Providers (SP); • Establishes terms on which SP provides services; • Agrees with LA Commissioner terms of Outcome Payments; and • Monitors and evaluates effectiveness of SPs in delivering the intervention.

Illustration of outcomes contract: Key to the SIB contract will be the obligations on both the commissioner and the delivery entity (service provider or SPV) to both mobilise the service and implement it well. This may cover such issues as promoting the service locally to ensure healthy referral volumes, or ensuring access to agencies such as Social Care where there is a need for interaction with a commissioner-led service. Access to high quality and timely data held by the commissioner will be a key obligation in order that outcomes can be tracked and payments calculated. It is important that the SIB contract focuses on outcomes in as far as possible, rather than inputs or prescriptive service delivery requirements. This flexibility should allow the SPV and service provider to evolve the nature of services to meet clients' needs.

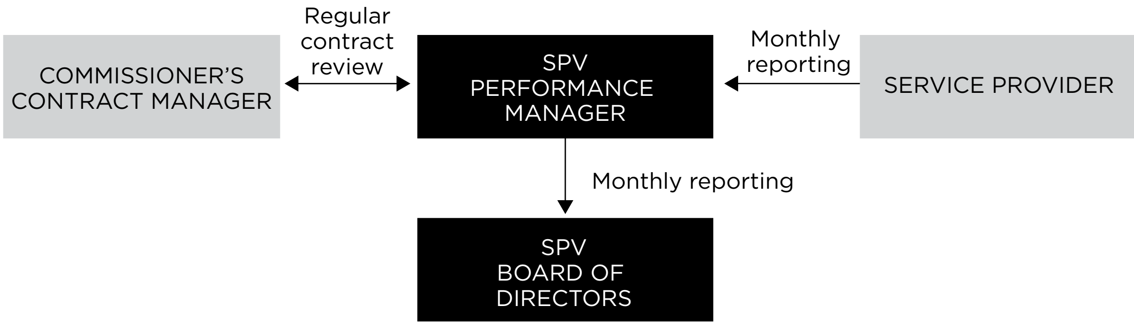
SIB Governance Structure

The SIB structure aims to ensure that the relative needs of each party is met:

- Commissioner(s) – statutory responsibilities will be adhered to and additional service will fit into existing service framework;
- Investors – as investors' money is at risk, it is important to ensure the services that have been commissioned have the best possible chance of achieving positive social outcomes; and

- Service providers – ability to deliver the service that best meets the needs of the target population

An example SIB governance structure is as follows:



Governance structures will exist at two levels:

- **Strategic**: on-going review of contract performance which could include operational model, implications of wider policy development. This could be carried out via the Contract Manager's regular review meetings.
- **Operational**: contract management, review of referral process, multi-agency advice on cases. This may be conducted by a Project Board convened by the commissioner and which might include multi-agency representation where appropriate.

Investment Raising process

At the point that the outcomes contract and governance arrangement is acceptable to all parties, the contract can then be signed. This allows the formal investment-raising process to commence.

Output

A fully-funded service that is ready to be mobilised and implemented. At this point, the service providers will prepare for implementation of the service.

12 Conclusion

This guide represents some of the lessons that Social Finance has learned in developing SIB for Vulnerable Children over the past two years. It is intended as a guide to help other practitioners develop new SIB programmes, both working with Vulnerable Children and in other social policy areas. We recognise that the development process will be different in other areas, often dependent on the needs and preferences of the Commissioner.

This is a rapidly-changing market and we would expect the way that SIBs are procured and contracted to evolve over time. However, the ultimate aim of SIBs is to enable improved social outcomes for those who use those services and we would expect this to remain the core principle behind the development of all future models.

APPENDICES

Appendix 1: SIB Questions to answer during the development of the value-for-money case

1. Social need	
What is the social issue you are trying to solve?	e.g. Improve outcomes for vulnerable young people in and on the edge of care
What are the systemic causes of this issue?	e.g. Under provision of services that address both the needs of young people at risk and their families
Are there interventions that have been shown to improve this issue?	
2. Outcomes	
What would the desired outcome of the social impact bond be?	e.g. Reduced entry into care or number of care weeks; improved social outcomes for young people
How would the improvement in the social outcome be measured?	e.g. Comparison data from other Local Authorities, distance travelled, historical comparison data
Are there existing objective measures of the outcome?	e.g. Government data on looked-after children population numbers and outcomes; National Indicators reflecting social outcomes
What is the current outcome for the target group?	e.g. 10–15 year olds make up more than 30% of those entering care; poor health and education outcomes
3. Target population	
How would you define the target group who would receive services funded by a SIB?	e.g. 10–15 year olds with behavioural problems referred to a resource panel in a particular Local Authority
Can you define the target group objectively?	e.g. 10–15 year olds, referred to particular panel where key risk factors are presented
What criteria would you use to define the target group objectively?	List of key risk factors
How do we identify people who are in the target group?	
How many people are in the target group?	
What are their needs?	e.g. Behavioural and emotional problems, domestic violence, offending behaviour, mental health problems, drug/alcohol abuse
How does the support need vary across the target group?	

4. Interventions	
What are the proposed interventions to be funded by a SIB?	e.g. Adolescents or family support services, counselling services, drug/alcohol services
What are the proposed organisations to be funded through a SIB?	
Is there evidence that these interventions are effective at achieving the desired social outcome?	
Is there a quantitative evidence base?	
Has an independent evaluation of the intervention been undertaken?	
How have these interventions improved the outcome	
How much do these interventions cost to deliver per person who receives them?	e.g. £10,000 per family

5. Value of the outcome	
Which government department(s) will financially benefit if the social outcome is achieved?	e.g. Local Authority Children's Services, DWP, DfE, Department of Health
How will these cost savings be achieved?	e.g. Reduced placement costs, reduced mental health needs, reduced levels of NEET, reduced youth offending and custody.
How much will the government save if the outcome is achieved?	e.g. Average placement cost per young person per year around £40,000–£200,000
Are these cost savings cashable?	i.e. Can the savings be realised (e.g. placements that are spot purchased are easily cashable)

Appendix 2: Social impact bond value-for-money case: contents checklist

This checklist is intended as a guide for stakeholders looking to complete a value-for-money case (also referred to as an Outline Business Case) for a Social Impact Bond proposal to fund interventions for Vulnerable Children (i.e. at risk of entering or currently in care):

SUGGESTED CONTENTS	OBJECTIVE	EXAMPLE	INCLUDED (Yes/No)
Social Impact Bond Target Population	To understand which group could benefit from additional services (e.g. historically poor outcomes, high cost group) To define the target population by age range and by need. This helps to produce a robust evaluation of current costs and a value-for-money case for improving outcomes To get an understanding of the current pathway (e.g. decision-making process for a child entering care from social services enquiry through to care placement). This helps to understand at what point in the process a child might become eligible for a SIB intervention	Trend analysis of care population and inflows (e.g. flows into care by age and referral type, care placements) Care journey analysis (e.g. historic trends on length of overall care journey, mix of placement types) Cost analysis (e.g. costs of typical care journeys, overall expenditure and key cost drivers) Needs analysis (e.g. major reasons for entering care) Pathway analysis (e.g. referral pathways map showing current service user journey)	
Assessment of potential intervention models (that could be funded by a SIB)	To understand which interventions could best meet the needs of the target population (as identified above) To provide recommendations on interventions that can improve outcomes (e.g. existing evidence base)	Summary of potential interventions (e.g. needs addressed, current evidence base, track record in local area) and evaluation of service gaps	
Recommendations for Outcome Metric(s)	To understand the outcome metric(s) by which the success of this intervention will be delivered To understand how this success might be measured and paid for	Recommendations for a potential payment mechanism, including: potential outcome metrics, proposed method of attribution of success (e.g. baseline definition) and payment timings	

SIB Financial Model	To understand whether: • Successful implementation of a new service would result in cost savings for a commissioner • These cost savings exceed the cost of delivering the service and potential investor returns as a reward for the service's success	Calculation of current government spending on target population Estimate of potential improvement in outcomes of new intervention(s) Estimate of potential reduction in government spending on target population Indicative investor cashflows Note: cost calculations likely to focus on outcome metrics. For example, if the primary metric was a reduction in care, the main cost calculation would relate to spending on care services.
Next Steps Recommendations	Ultimately a SIB takes the form of a contract between investors and commissioners. This section highlights the points needed to get to a proposition that investors are willing to invest in and commissioners are willing to procure	Service delivery – details on potential operating and implementation plans Governance – roles for key stakeholders (e.g. SIB delivery entity, investors, commissioner, service provider and performance manager) Investor interest – initial indication of potential interest in SIB proposal

Note: This checklist is intended for guidance only and is based on Social Finance's experience to date of developing Social Impact Bond proposals for vulnerable children and across other areas of social policy.

1 Schedule 1 of the Public Contracts Regulations 2006 lists central government bodies subject to the World Trade Organisation's (WTO) Government Procurement Agreement (GPA). These thresholds will also apply to any successor bodies.

2 With the exception of the following services, which have a threshold of £156,442 (€193,000): Part B (residual) services; Research & Development Services (Category 8); Some telecommunications services and subsidised services contracts.

ABOUT THE AUTHORS

Lisa Barclay

Lisa is a Director at Social Finance having joined the team in 2010. She leads the organisation's work on Social Impact Bond development around children and families. In 2011 Lisa led Social Finance's work developing the UK's first local authority Social Impact Bond, for adolescents on the edge of care in Essex. She has also worked with a number of other local authorities, including Havering and Liverpool, in SIB feasibility work. Lisa has been involved with social investment for the past nine years, and prior to that was a Special Advisor at the Department for Education and co-founded a small business.

Tom Symons

Tom is an Associate at Social Finance and joined the team in 2012. His main area of work is the development of Social Impact Bonds for local authorities and the health sector. His work includes the social issue areas of children, complex families as well as health and social care integration. Before joining Social Finance Tom worked in a number of roles across the local government sector, most recently as an Advisor in the finance team at the Local Government Association, specialising in public service reform and local economic development. Prior to that Tom was a Senior Researcher at the New Local Government Network where he published widely on a range of topics, including public sector efficiencies and service redesign. Tom began his career at the London Borough of Islington.

WE BELIEVE THAT IF SOCIAL PROBLEMS ARE TO BE TACKLED SUCCESSFULLY, THE ORGANISATIONS SEEKING TO SOLVE THEM NEED SUSTAINABLE REVENUES AND INVESTMENT TO INNOVATE AND GROW.

Our role is to devise the financial structures and raise the capital to enable this to happen.

Social Finance injects market principles into funding in a way that stands or falls on results – both social and financial. We support social organisations to raise and deploy capital; we work with government to deliver social change; and we develop social investment markets and opportunities.

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Changes in Philanthropy: Emerging Outcomes Based Funding Environment

Presented for:

Children & Families Commission of Orange County Annual Planning Meeting

Presented by:

Jessica LaBarbera
Director, Nonprofit Finance Fund

June 4, 2014

NFF as Trusted Advisor – 30+ Years Linking Money to Mission

Nonprofit Finance Fund

Access to Capital	Strategic Financial Analysis, Management & Planning Services
Loans and Lines of Credit New Market Tax Credits PRI Services Pooled Financing Programs Growth Capital Services	Financial Diagnostics, Program Economic and Scenario Modeling, Capitalization Planning Business Model Analysis, Modeling & Repositioning Strategic Collaboration Planning Facility and Reserve Planning
Impact Investing	**Thought Leadership & Partnership**
Field Development Capital Aggregation Philanthropic Advisory Work Provider Readiness Trainings Complete "Stacked" Capital Structured Finance	***Pay-for-Success and Social Impact Bonds*** www.payforsuccess.org Studies of the Nonprofit Economy Advocacy on Funder Policies and Practices Publishing, Expert Commentary, Keynotes, Workshops & Panels

NFF: Supporting Field Development and Investment Readiness for Outcomes Based Funding

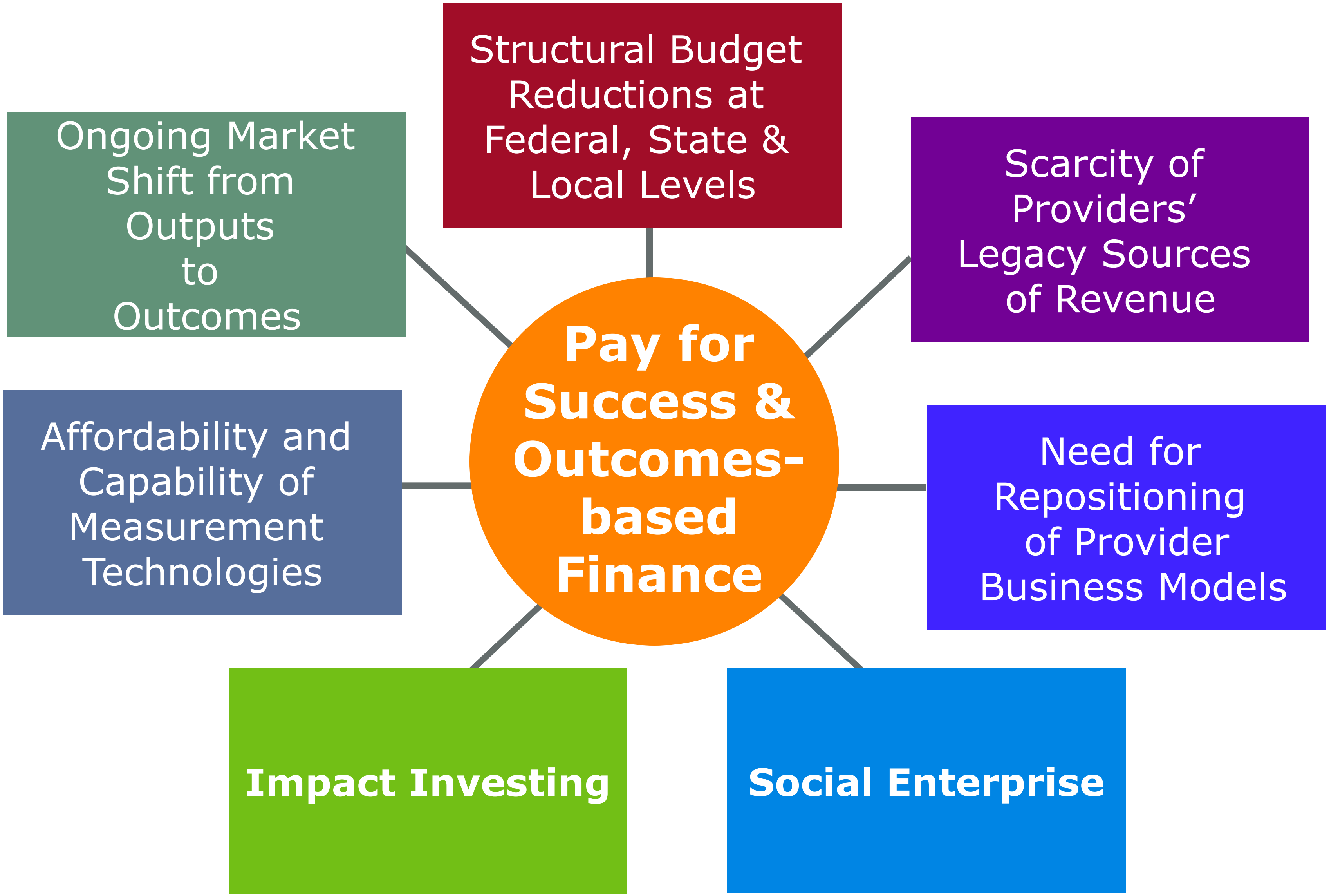
Nonprofit Finance Fund

Act as an independent, honest broker to the "PFS" field

- Support various PFS approaches and stakeholders as they explore this new "outcomes-based" financing model
- Spread recognition of why and how the PFS outcomes-based financing approaches can be effective
- Identify, disseminate and support PFS structures that can work
- Build and manage structured partnership initiatives for accelerated learning and application of PFS among stakeholders
- Incubate and accelerate providers' capacity to thrive in an outcomes-based environment

Establish a centralized and interactive education platform for information, best practices sharing and dialogue on PFS – the NFF *Learning Hub:* **www.payforsuccess.org**

Outcomes-based Finance: The Missing Hub in the Wheel of Systemic Change?



Pay for Success: A Model that Drives Towards Outcomes

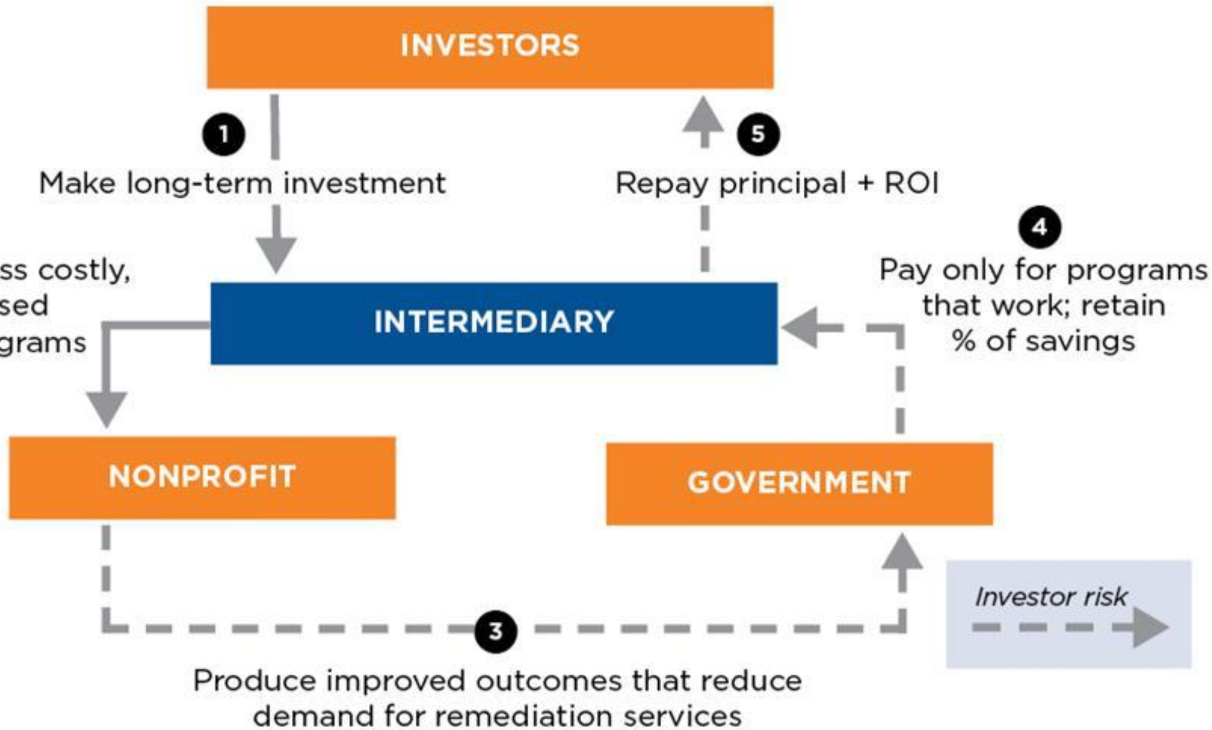
Nonprofit Finance Fund

- **A *contract* (not necessarily a bond) that:**
  - Connects performance outcomes to financial return
  - Monetizes social impact/outcomes
  - Realizes costs savings (typically for government)
  - Leverages private capital
- **Innovative integration** of evolving practices (i.e., pay for performance, outcomes measurement) in the social sector at an opportune time– ***aligns interests in achieving social outcomes***
- **Social Impact Bond** is one of potentially many ways to *capture the embedded values and linkages of **pay-for-success financing***

Pay for Success:
How a Transaction "Flows"

Original and piloted structure (Peterborough) effectively creates and incentivizes mutual interest in achieving outcomes

FIGURE 1 **SOCIAL IMPACT BOND MECHANICS**



Source: Social Finance USA: Adapted from Jeffrey B. Liebman, "Social Impact Bonds," Center for American Progress (February 2011)

Pay for Success: Embedded Values

Nonprofit Finance Fund

A New Approach for Financing *Certain* Social Programs

1. Multi-year Contract from private investors for preventative services delivered by qualified provider(s)

2. Invested capital supports positive outcomes that produce cash flow savings and/or revenues against legacy government program costs

3. Investment Success = Achieving contractually agreed social outcome targets (Metric and Timing)

4. Measurement of Social Outcomes against contracted targets is done by independent experts

5. Most or all outcome performance risk is shifted from the government funder to private investors and/or providers

6. Government Funder is obligated to pay investors from portion of cash flow ONLY IF contracted social outcome targets are hit

7. Government Funder pays nothing if targets not reached OR retains a contracted portion of cash flow from successful investments

Pay For Success: US Market Evolution

Summer 2012

- New York City – launched first fully-funded Social Impact Bond (SIB) transaction in U.S.
- Massachusetts – announced two SIB contracts (*unfunded*)
  - One contract to address recidivism among youth
  - Second contract to address chronic homelessness in Boston area

2013-2014

- First Early Education SIB Pilot Announced (Salt Lake City)
- NY State SIB launched
- MA ROCA transaction launched

Today

- Over 30 State, County and Municipal Governments Assessing Feasibility and Developing Pay-for-Success Projects
  - *Intervention under consideration in Chicago, Philadelphia, SC, MI, CA, CO, IL, OR, VT, NJ*
  - *NFF/Irvine CA PFS Initiative*
- Pay-for-Success being incentivized at the Federal Government Level
  - Federal Budget Proposals
  - Department of Labor -$20 million
  - Department of Justice - Second Chances Act (recidivism reduction)

Promising Programs & Approaches in the Early Childhood Space

Programmatic Approach	Organization	Target Population	Outcomes
Pre-school setting with structured data tracking	Voices for Children Utah, Granite City School District	At-risk Preschool – age children	Reduction in need for special education services, education benefits include improved 3rd grade scores. Longer term benefits include reduced crime, better wages.
Home visitation program by RNs	Nurse Family Partnership	Low-income, first time mothers & children	Improved prenatal health, intervals between births, maternal employment, child school readiness Fewer childhood injuries & subsequent pregnancies
Triple P (Positive Parenting Program)	Multiple	At Risk Families with children 0-8	Reduced rates of child maltreatment, fewer foster placements, fewer hospitalization/ER visits for child maltreatment
Pre-school setting with structured data tracking	Pre-K Counts (multiple partners)	At Risk Preschool Children in PA	Improved kindergarten readiness

Utah High Quality Preschool Program

- Goals of increasing access to preschool, increased school readiness and decreased use of special education services
- **Success payments tied to decreased use of special education services through 6th grade**
- Private capital enables 450-600 3 and 4 yr olds in yr 1 to attend pre-school; potential to reach over 3,5000 over 5 yrs
- Up to $4.6M from Goldman Sachs and $2.4M subdebt from J.B. Pritzker Foundation to finance an expansion of the Utah High Quality Preschool Program in Granite and Park City School Districts
- United Way of Salt Lake oversees preschool programs implementation and manages repayments to private investors
- Public funding from County School Districts and State Department of Education provide repayment

Nurse Family Partnership: PFS pursuit as a means to scale delivery

- Targets high-risk (low-income) mothers' first pregnancies
- Home visitation by registered nurses from pregnancy – age 2
- Effectiveness proven in 4 random controlled trials plus > 20 other rigorous evaluations
- Cost-benefit analyses showing positive ROI
- NFP infrastructure supports replication with fidelity to model
- Possible Health Outcomes for PFS Contract:
  - Fewer pre-term births, infant deaths, child emergency department visits, closely spaced second births, subsequent births or subsequent preterm births
  - Increase in children fully immunized
- Possible Other Outcomes for PFS Contract:
  - Child welfare: Fewer incidences of child abuse or neglect
  - Education: Fewer remedial school services through age 6
  - Criminal justice: Fewer youth crimes through age 17
  - Maternal life-course : Increased employment, decreased TANF use

California PFS Initiative

With initial support of **$2.5M from the James Irvine Foundation**, NFF is implementing a California PFS initiative

- The core initiative goal is to **close 3 PFS deals in CA in 2 years**, and to create a cohort of PFS leaders to capture and disseminate knowledge about the process
- ~$2Mof the grant will be used to offer **technical assistance** to leaders aiming to close PFS deals in their communities
- NFF will manage the provision of technical assistance to the leaders through **qualified intermediaries**
- NFF will also manage the creation of an **Funder Interest Group**, which will give feedback to leaders on deal structure and potentially offer investments for PFS deals
- NFF will create a **community of learning** among cohort leaders to accelerate the sharing of lessons learned and disseminate those lessons more broadly within the PFS field in CA

Framework for Considering Stages of PFS Project Development

Stage 1: Exploration	Stage 2: Pre-Structuring	Stage 3: Transaction Structuring	Stage 4: Shovel Ready
• Conversation among local stakeholders is occurring • Education efforts have been undertaken/ are under way • Initial ideas for suitable PFS projects are being discussed, considered, prioritized • Government officials have expressed interest in PFS	• Informed consideration or due diligence of effective interventions/ programs that could be right for PFS in a community is underway • Evidence to support the efficacy of such high-impact programs is being collected and evaluated by stakeholders • Governments are undertaking (or engaging third parties to undertake) feasibility assessments and/or cost benefit analyses that look at the relative merits of scaling or implementing programs in a community • Such feasibility assessments or cost benefit analyses determine the potential cost savings generated by projects under consideration	• Governments (or the back-end payors in a non-governmental transaction) have reviewed the due diligence completed for a potential project and committed to moving forward with structuring a PFS transaction • A third party is engaged to structure a transaction, refine the program design and consider the delivery implications of a scaled project • A procurement process (or direct engagement) of involved parties (providers, evaluators and intermediaries) takes place • Potential investors are engaged	• Most, if not all, stakeholders (providers, evaluators, intermediaries, government agencies) have committed to the project • The transaction has been substantially structured; Exact program design elements may need to be finalized • Investors, investor terms or specific project design elements may remain outstanding/ need to be negotiated • Contracts need to be negotiated

Barriers to Systemic Adaptation

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Gaps in Data, Evaluation, Evidence Base

Early Stages/ Proof

Flawed Funding Systems

Organization & Funder Readiness

Uncertainties over cost of measurement

Scaling/ Replication challenges

Challenges for Building an Outcomes Based Financing Environment

Inflection Point in the Systemic Shift from "Outputs" to "Outcomes"

Nonprofit Finance Fund

The Appeal and Possibilities of PFS Embedded Values And Linkages

- Promotes more efficient and effective outcomes-driven service delivery: programs that work
- Monetizes the positive social impact of prevention & early intervention
- Cost savings or revenues plus lower risk to governments compared to current practices
- Aligns interest of investors, providers & governments on positive social outcomes
- Integrates social & financial ROI for the private impact investor pool and suggests scalability
- More productive allocation of risk among investors, governments & service providers

Considerations for Assessing Service Provider "Right Fit" and Readiness

- **Deliver preventative or early intervention programs**
  - Government funding provides a substantial percentage of support for these programs
  - Program provision can provide financial benefit to government funders
- **History of evidence-based outcome metrics to evaluate performance**
  - Track record of success in achieving outcome targets in reasonably compact timeframe (1 to 6 years)
- **Organizational capacity to:**
  - Reach population needed for statistical significance
  - Collaborate with other providers
  - Ability to track capital investment (and perhaps create business models)
- **Governing body supportive of PFS participation, capacity demands and reputational risk involved**
- **Financial health and durability required for participation**

Different Kinds of Capital Address Different Needs

Nonprofit Finance Fund

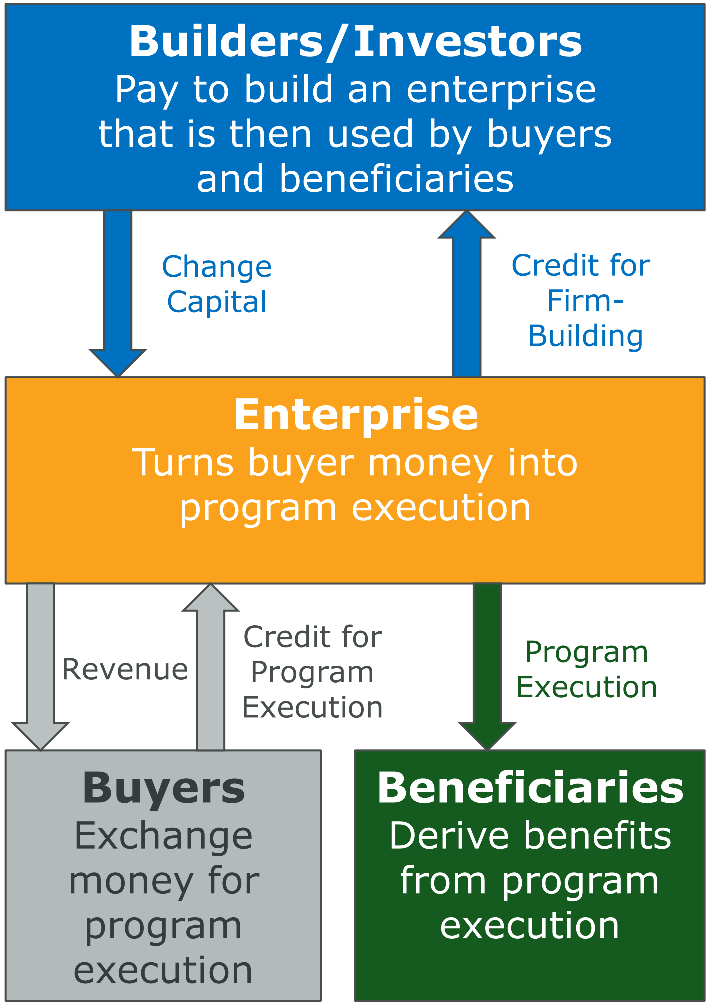
Capital Types	Function of each	Addresses:
Working	Allows the organization to bridge revenue timing gaps	Liquidity
Risk & Opportunity	Absorbs unforeseen funding losses or unexpected, extraordinary expenses	Adaptability
Change	Funds investments in infrastructure and capacity associated with changes in business model, may cover deficits until programs and operations can support themselves	Adaptability, Durability
Recovery	Allows an organization to address a historical mistake or chronically undercapitalized operations	Durability
Facilities & Equipment	Supports acquisitions or upgrades, or can be used to accumulate reserves to meet future facility and equipment needs	Durability
Endowment	Provides ongoing operating funds through investment income	Durability

Change Capital (not revenue!) Promotes Adaptability & Durability

There are two kinds of funding:

- **Revenue from "Buyers" provides regular revenue**
  - Covers annual costs of programs & operations
  - Ticket sales, membership fees, program grants, contracts, etc.
- **"Change" capital from "Builders"**
  - Funds the enterprise: to transform what it does
  - Tends to be episodic in nature
  - Can enable growth and experimentation, or provides for risk reserve or deficit coverage

Nonprofits need both revenue and capital to thrive!



General Lessons Learned (to date)

- **Local Context Matters:** Recent US PFS/SIB activity has organized differently according to local conditions-- initial champions have varied, as have resulting structures. One size will not fit all.

- **Independent & Trustworthy Voice Needed:** Given different interests and natural tensions between government, service providers, intermediaries, and investors, maintaining trust among all parties as an objective broker is essential to mobilizing the effort.

- **Catalysts Can Drive Timing:** Government processes and approvals differ. Even with MA/NYC experiences to draw from, RFPs and contracting can still require extended time periods. Moving aggressively through the process requires an incentive.

- **Targeted Technical Expertise Will Be Required:** Depending on capacity of local players, stakeholders will likely need tailored modeling structuring and facilitation support.

- **Broad Stakeholder Engagement is Essential:** Government champion is critical, but not independent of the stakeholder group, including capable intermediaries, strong service providers and evaluators, and engaged investors.

Thank You!
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FACT SHEET: The Utah High Quality Preschool Program

America's First Social Impact Bond targeting early Childhood Education

- **Social Impact Bonds** are innovative and emerging financing instruments that leverage private investment to support high impact social programs. In 2010, the UK government, along with philanthropic partners, piloted this approach. In 2012, Goldman Sachs was the first financial institution to invest in this product to finance preventative services for youth on Rikers Island

- **The Utah High Quality Preschool Program** delivers a high impact and targeted curriculum to increase school readiness and academic performance among 3 and 4 year olds. As a result of entering kindergarten better prepared, it is expected that fewer children will use special education and remedial services in kindergarten through 12th grade, which results in cost savings for school districts, the State of Utah and other government entities. The first $1 million investment in this program will enable 450-600 children to attend pre-school this Fall

- Private capital from J.B. Pritzker and Goldman Sachs will finance an expansion of the Utah High Quality Preschool Program to provide early education services to up to five cohorts totaling over 3,500 children. In this approach, there is no upfront cost to the taxpayer or other funders, instead:

  — **Goldman Sachs** loans up to $4.6 million to United Way of Salt Lake

  — **J.B. Pritzker** provides a subordinate loan up to $2.4mm to United Way of Salt Lake, reducing risk to the senior lender if the preschool program proves to be ineffective

  — **United Way of Salt Lake** oversees the daily implementation of the Utah High Quality Preschool Program in Granite School District and Park City School District. United Way of Salt Lake is also responsible for managing repayments to the private investors

  — **Private capital and other public funding sources** provide Pay-for-Success payments to repay the loans, based on the cost-savings associated with the reduced use of special education and ancillary services

  — If the preschool program does not result in increased school readiness and decreased use of special education services, then there is no obligation on the part of United Way or other public funding sources to repay the social impact loan

  — **After initial funding**, subsequent investments will be made based on the availability of repayment funds from public entities that are realizing cost savings as a result of the program

- Determining **Pay-for-Success Payments**:

  — Children participating in the high impact preschool program will take a Peabody Picture Vocabulary Test which is a predictive evaluation that will serve as an indicator of their likely usage of special education and remedial services. Students that test below average and are therefore likely to use special education services will be tracked as they progress through 6th grade

  — Every year that they do not use special education or remedial services will generate a Pay-for-Success payment

  — School districts receive a fixed per annum payment of approximately $2,600 per student to provide special education and remedial services for students in general education classrooms from the State of Utah. The amount of the Pay-for-Success payment is based on the actual avoided costs realized by the State of Utah

- Pay-for-Success payments will be made equal to 95% of the avoided costs or $2,470 per child for every year, Kindergarten through Sixth Grade, to repay the senior and subordinate debt plus a base interest rate of 5.0%
- Thereafter, Success Payments will equal 40% of the savings, or $1,040 per child per year of special education services avoided, to be paid as Success Fees to Goldman Sachs and Pritzker

■ The Utah High Quality Preschool Program has the potential to generate long-term savings for taxpayers and the Social Impact Bond structure can become a replicable model for financing early childhood services nationally
  - The potential savings associated with the reduction in special education and remedial service usage are significant, and in each scenario exceed the potential payments to the lenders
  - Pay-for-Success payments are only made through 6^{th} grade for each student; but all savings that are generated after that point will be captured by the school district, state and other government entities

Climbing the Pay for Success Learning Curve:

How a working group helped South Carolina understand and prepare for PFS financing

March 2014

i(cs)

INSTITUTE *for* CHILD SUCCESS

In January 2013, few people in South Carolina had ever heard of Pay for Success financing (PFS), a new approach to funding solutions to difficult social problems. PFS uses private and philanthropic capital to expand successful projects, even when government budgets are strapped.

But by September of that year, the state had expressed interest in using PFS to improve maternal and child health, issuing a "request for information" seeking formal input on how this financing mechanism could be implemented. Foundations, banks, and other groups were excited about the prospect of investing in PFS.

These stakeholders were excited because they were ready. In the intervening months, government officials, service providers, local foundations, academics, legislators, and potential investors had come together to delve into the subject of PFS financing from many angles. They learned about PFS in other jurisdictions, considered how it could apply in their areas, identified challenges and benefits, and brainstormed ways to overcome thorny implementation issues.

The nonprofit Institute for Child Success (ICS) convened the working group that sparked this transformation. This document describes lessons learned from the experience, providing a roadmap for those who wish to convene similar working groups to explore PFS financing.

HOW DOES PAY FOR SUCCESS WORK?

With PFS (also called Social Impact Bonds, or SIBs), philanthropic funders and private "impact investors" provide the initial capital to scale up successful programs, which are run by nonprofits. Government does not pay for the expansion (private investors do); instead, it pays only for agreed-upon outcomes, which must be verified. PFS projects are typically managed by an intermediary organization.

The PFS model solves a common problem—government's insufficient resources for expanding proven social programs—by securing capital from private sources. If successful, a PFS project will eventually save government money, which it can then use to repay investors. PFS has the additional benefits of increasing accountability for government spending and advancing partnerships between the public and private sectors.

In This Brief:

(by)
Megan Golden
Fellow
Institute for Child Success

(establishing a working group to explore PFS for South Carolina)

The Institute for Child Success (ICS) is committed to improving the systems that serve children from before birth through age five to ensure that all children succeed. South Carolina has implemented programs that improve children's health and well being, but these programs serve only a small fraction of those who need them. Meanwhile, funding that could help expand effective preventive programs is tied up in responding to the very problems that could have been avoided in the first place through these programs. These problems include child abuse, unidentified learning disabilities, and crime.

PFS financing addresses this conundrum by leveraging private funding to bring effective programs to scale and enabling government to pay later, once it has evidence that cost-saving outcomes will be achieved. ICS believed PFS was a promising way to bring much-needed resources to children in their earliest years.

WORKING GROUP GOALS

1. To educate a wide range of potential stakeholders about Pay for Success financing.
2. To consider the potential of PFS financing to help South Carolina address social problems on a large scale.
3. To get stakeholders started on building capacity for PFS financing and planning PFS projects where appropriate.

Since PFS financing requires the private, public, nonprofit, and philanthropic sectors to work together, ICS felt it would be best for all of the potential stakeholders to explore this new financing mechanism in a single working group. The response to the Institute's invitation to participate was enthusiastic, with 50 people taking part. (A list of members can be found on pages 6-7.)

The Duke Endowment and the Doris Duke Charitable Foundation provided support for planning and meeting expenses. The working group met six times in person and by webinar in 2013. Below we share three strategies that contributed to the working group's success, as well as potential pitfalls other jurisdictions should plan to avoid.

(three key strategies for a successful PFS working group)

1. Include all of the many stakeholders, including senior government officials

It takes many parties to make Pay for Success work. PFS requires government to pay for outcomes. Thus, the legislature, executive branch, or both must commit funds, an executive branch agency must lead a procurement process and facilitate implementation, and officials at the highest level of government must provide the political leadership needed for a new approach.

In addition, investors, service providers, researchers, and intermediaries need to participate in a transaction. Other experts and community leaders provide important outside scrutiny to make sure any deal serves the community's needs.

ICS included all of these stakeholders in the working group and provided information specific to each one's role. For example, at one meeting, Rick Edwards, partner at the intermediary Third Sector Capital Partners, led an exercise in which participants broke out into groups by sector and considered a hypothetical PFS transaction. The subsequent discussion brought to light multiple perspectives on the same situation and helped participants understand each others' viewpoints.

STAKEHOLDERS REPRESENTED*

- Executive Branch (Governor's Office and state agency leadership)
- Legislature
- Service Providers
- Foundations
- Universities
- Banks
- Chambers of Commerce

*see list of members on pages 6-7

2. Analyze real-life examples

Pay for Success financing is terrific in theory, but what does it mean in practice?

To answer this critical question, South Carolina's working group plunged into the details of the single PFS transaction that had been announced in the United States (in New York City), as well as other deals that were nearing completion. The working group worked closely with experts in this emerging field.

At the initial meeting, Megan Golden of the NYU Wagner School's Innovation Labs, an authority on new nonprofit financing methods, shared information on the payment terms and parameters of the New York City project, which focuses on reducing recidivism. In a subsequent webinar, the group heard from Liz Gaynes, executive director of the Osborne Association, which is providing the bulk of the services to the teenage boys in the New York City project. Gaynes shared Osborne's experience as the only US organization actually implementing a PFS project, describing challenges as well as benefits.

> "The collaboration between funders, scholars, state agency representatives, and service providers demonstrates a solid momentum building between theory and action. Being able to engage with this working group has challenged GEEARS and our partners to accelerate our conversations around the possibilities for PFS in Georgia."
>
> - Laura Stamm Wagner
> Director of Research
> Georgia Early Education Alliance
> for Ready Students

Nirav Shah from Social Finance, a nonprofit dedicated to promoting private investment in solving social problems, reviewed PFS transactions in development around the country. Rob Dugger of ReadyNation, which brings business support to investments in early childhood, discussed his organization's work applying PFS financing to pre-kindergarten programs. Rick Edwards of Third Sector Capital Partners, an intermediary, presented the project being developed with the nonprofit group Roca in Massachusetts. By the last meeting, working group members were well versed in how PFS financing can apply in multiple settings and how the field was progressing.

2013 WORKING GROUP MEETING TIME LINE

- February 7, 2013: Intro to social impact finance (In-person meeting)
- April 15, 2013: The investor's perspective (Webinar)
- April 23, 2013: In-depth analysis of PFS transactions in development and break-out groups by sector (In-person meeting)
- May 22, 2013: The service provider's perspective (Webinar)
- August 27, 2013: Presentation of ICS feasibility study on PFS finance for the Nurse-Family Partnership (In-person meeting)
- October 30, 2013: Progress and next steps in SC and internationally; needs and opportunities for capacity building (Final in-person meeting)

3. Encourage challenging questions and creative ideas

The working group was not a marketing vehicle for PFS financing. In fact, it encouraged participants to bring up any challenges or obstacles they saw to PFS.

And they did. For example, program managers raised the concern that they would not be able to secure data on outcomes that occur after participants complete a program. The facilitators and other working group members acknowledged the obstacles and brainstormed ways around them. In this case, researchers in the group were able to talk about what data is available and suggest ways of accessing it.

It helped that the working group's convener, the Institute for Child Success, was not interested in being a party to any eventual PFS transaction.

(potential pitfalls that working groups should consider)

"As government budgets tighten, it is critical that we develop alternative means of financing important interventions to support our youngest learners. The working group was exposed to real world practitioners of pay for success. We were educated about the value and the challenges of establishing these models."

- Dave Morley
Board Member
Past National Chair
Parents As Teachers (PAT)

CHALLENGE: **Pursuing opportunities for PFS funding is time consuming and requires resources.**

SOLUTION: **Set realistic expectations—understand that the working group will lay crucial groundwork, but more time and resources will be needed to evaluate actual potential deals for PFS.**

ICS initially envisioned that, after some preliminary education, working group members would quickly begin exploring opportunities for PFS financing and share them with the group.

However, we soon realized that that was too much to expect. Understanding PFS financing and its implications itself takes time. Exploring actual opportunities for implementing it requires resources beyond what working group participants could typically devote.

This experience provides an important

warning: while a working group can lay the groundwork for PFS financing, exploring an actual deal requires detailed analysis that takes time and costs money. If the working group operates on a limited budget, as did the South Carolina group, this work must be done with additional, dedicated resources.

The Institute's study of the feasibility of using Pay for Success financing to expand the Nurse-Family Partnership, an evidence-based early childhood program, is one example of a dedicated effort to evaluate a specific opportunity for PFS financing.

ASSESSING PFS FINANCING FOR A SPECIFIC INTERVENTION: ICS'S FEASIBILITY STUDY OF THE NURSE-FAMILY PARTNERSHIP

While leading the working group, ICS conducted a separate, eight-month feasibility study, on whether PFS financing could be used to scale up the Nurse-Family Partnership, a successful early childhood intervention. Supported by additional funding, this study, *Using Pay for Success Financing to Improve Outcomes for South Carolina's Children*, concluded that PFS could indeed be used to expand early childhood programming such as the Nurse-Family Partnership. It is available at www.instituteforchildsuccess.org.

During the study, ICS sought input from working group members, as well as other interested parties. This input enabled ICS to identify and respond to many valid concerns and solidified our confidence in our finding that PFS is indeed a feasible way to improve outcomes for South Carolina's children.

CHALLENGE: Geographic and time restrictions make it hard to attend meetings.

SOLUTION: Strategically schedule meetings in locations and at times that make it easy and worthwhile to attend.

ICS held the working group meetings in Columbia, the state capital, which was less than a two-hour drive for participants coming from other parts of the state. Even so, it was difficult to get full attendance at all of the in-person meetings.

This experience suggests that other jurisdictions would be wise to schedule in-person meetings strategically, either planning around other big events that bring people to the meeting location or providing a compelling and substantial-enough agenda to warrant significant travel. Larger states might consider convening regional, rather than statewide, working groups.

> "The Mary Black Foundation, like many funders, wants to be able to maximize our impact and leverage other resources for our community. Social Impact Financing or Pay for Success models are intriguing ways for foundations to think about growing successful programs and improving outcomes for children on a much larger scale than we might be able to achieve on our own. It's important for us to participate in conversations, like the Working Group, about new and different ways to do our work of creating community change."
>
> - Molly Talbot-Metz
> Vice President of Programs
> The Mary Black Foundation

(conclusion)

South Carolina's experience shows that a working group can help a critical mass of stakeholders understand the value and constraints of Pay for Success financing.

That understanding can generate ideas for applying PFS financing to address pressing social problems, speed the time to complete any PFS transactions, and promote collaboration to achieve the best results for taxpayers and communities.

(South Carolina PFS working group members)

Sally Baggett
Carolina Health Centers

Tamar Bauer
Nurse-Family Partnership

Taylor Beard
Grace Church

Bonnie Bella
Trident United Way

Eric Bellamy
Children's Trust of South Carolina

Anne Bergin
Trident United Way

Chris Bishop
Nurse-Family Partnership

Edie Blakeslee
Coastal Community Foundation

Leigh Bolick
South Carolina Department of Social Services

Megan Branham
Children's Trust of South Carolina

Mike Brenan
BB&T

Erica Brown
Harvard SIB Lab

Sam Cook
Center for Heirs' Property Preservation

Edna Crews
Coastal Community Foundation

Wanda Crotwell
Mike Daniel & Associates

Todd Dalrymple
The Duke Endowment

Leigh D'Amico
University of South Carolina

Susan DeVenny
South Carolina First Steps

Tim Ervolina
United Way Association of South Carolina

Mike Fair
South Carolina Senate

Megan Golden
New York University

Gwynne Goodlett
USC School of Law - Children's Law Center

Ted Hendry
United Way of Greenville County

Derek Lewis
Greenville First Steps

Steven Lize
Consultant

Rhett Mabry
The Duke Endowment

Steve Mann
University of South Carolina

Laura McKinney
New Carolina

Molly Talbot-Metz
Mary Black Foundation

Dave Morley
New Carolina
Parents as Teachers

Jamie Moon
Institute for Child Success

Amy Nienhuis
Children's Trust of South Carolina

Jim Reynolds
Total Comfort Solutions

Terry Richardson
RPWB

Debbie Robertson
South Carolina First Steps

Ann Robinson
CertusBank

Geales Sands
Frances P. Bunnelle Foundation

Susan Thomson Shi
Institute for Child Success

Katy Sides
Institute for Child Success

Michael Smith
South Carolina Department of Health and Environmental Control

Lisa Sox
South Carolina Senate Labor, Commerce & Industry Committee

Christian Soura
Office of Governor Nikki R. Haley

Laura Stamm Wagner
GEARS (Georgia Early Education Alliance for Ready Students)

Anne Wallice
South Carolina Senate Committee on Corrections and Penology

Bunnie Ward
United Way of the Midlands

Joe Waters
Institute for Child Success

Gage Weekes
Hollingsworth Funds

Sue Williams
Children's Trust of South Carolina

Jane Witowski
Greenville Health System

Amanda Wuenscher
Mike Daniel & Associates

Dan Wuori
South Carolina First Steps

This information is provided here for informational purposes only and is not intended to imply endorsement of the findings of this working group or the contents of this final report.

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POWERED BY Children's Hospital Greenville Health System · United Way of Greenville County

The Institute for Child Success is a non-profit, non-partisan research and policy organization that fosters public and private partnerships to align and improve resources for the success of young children in South Carolina. A partnership of the Children's Hospital of the Greenville Health System and the United Way of Greenville County, ICS supports service providers, policy makers, and advocates focused on early childhood development, healthcare, and education to build a sustainable system that ensures the success of all children, pre-natal through age five.

SOUTH CAROLINA PAY FOR SUCCESS FEASIBILITY STUDY

Early Childhood Social Impact Finance Panel

June 25, 2013

Megan Golden, Consultant to the Institute for Child Success

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Nurse-Family Partnership

- Targets high-risk (low-income) mothers' first pregnancies
- Home visitation by registered nurses from pregnancy through age 2
- Effectiveness proven in 4 random controlled trials plus > 20 other rigorous evaluations
- Cost-benefit analyses showing positive ROI
- Interested in PFS financing
- NFP infrastructure supports implementation with fidelity to model

Proven Benefits of Expanding NFP

- Fewer preterm births
- Fewer injury-related visits to the emergency room
- Reductions in child abuse and neglect
- Children more ready for kindergarten
- Fewer closely-spaced 2nd births => lower risk
- Moms more economically independent

NFP Benefits Far Exceed Costs

RAND Corporation*	Pacific Institute for Research and Evaluation**	Washington State Institute for Public Policy***
$5.70 return for every dollar invested on high- risk families (current NFP target population); $1.26 return for lower-risk families	Net return of $44,510 per family; benefit-cost ration of 6.2 to 1	Long-term net return of $13,181 per person; $2.37 return per dollar (does not include any health benefits or Medicaid savings)

Source: * *RAND Corporation, Early Childhood Interventions: Proven Results Future Promise* (2005), p 109
** *Miller, Cost Savings of Nurse-Family Partnership Home Visitation: Costs, Outcomes, and Return on Investment,* April 2013, Executive Summary, p 4
*** *Washington St. Inst. For Public Policy, Nurse-Family Partnership for Low-Income Families* (April 2012)

Benefits of NFP to SC's Economy

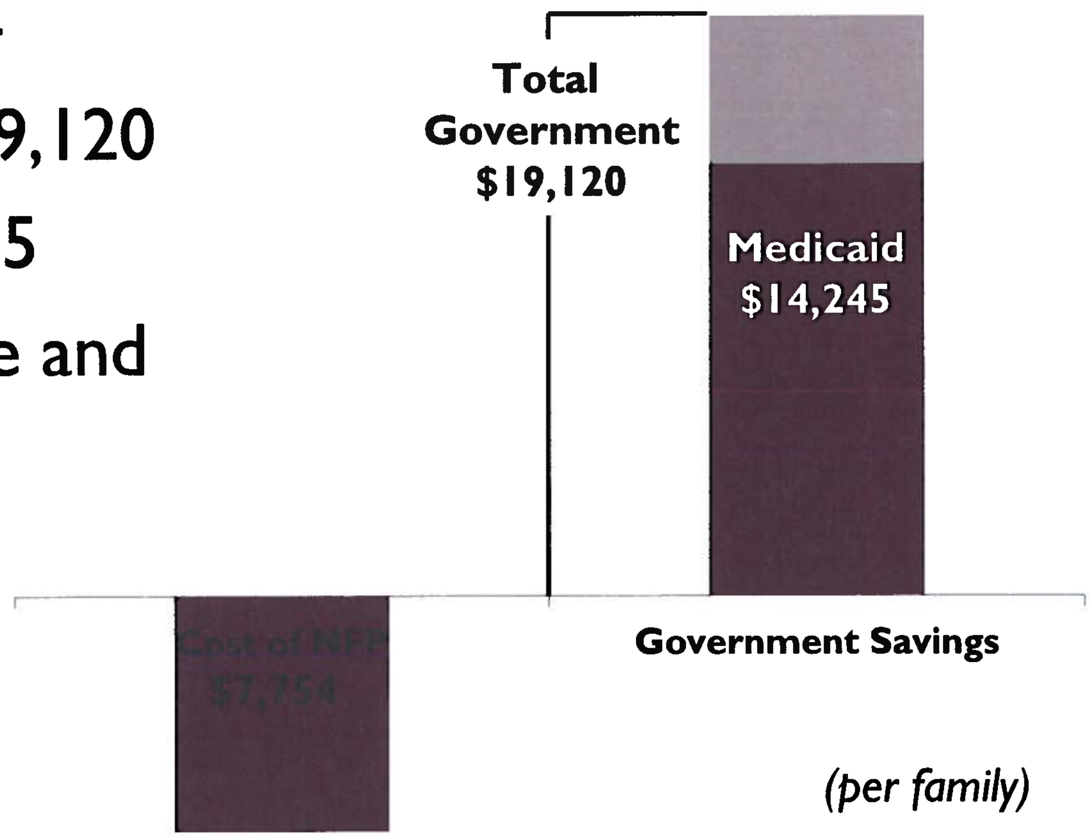
Economic benefits alone produce an 85% return on investment

- education, employment, wages of former child participants
- education or labor supply of parents
- employment, wages, economic activity from program expansion

Source: *Bartik, Timothy, Investing in Kids* (2011), p 81

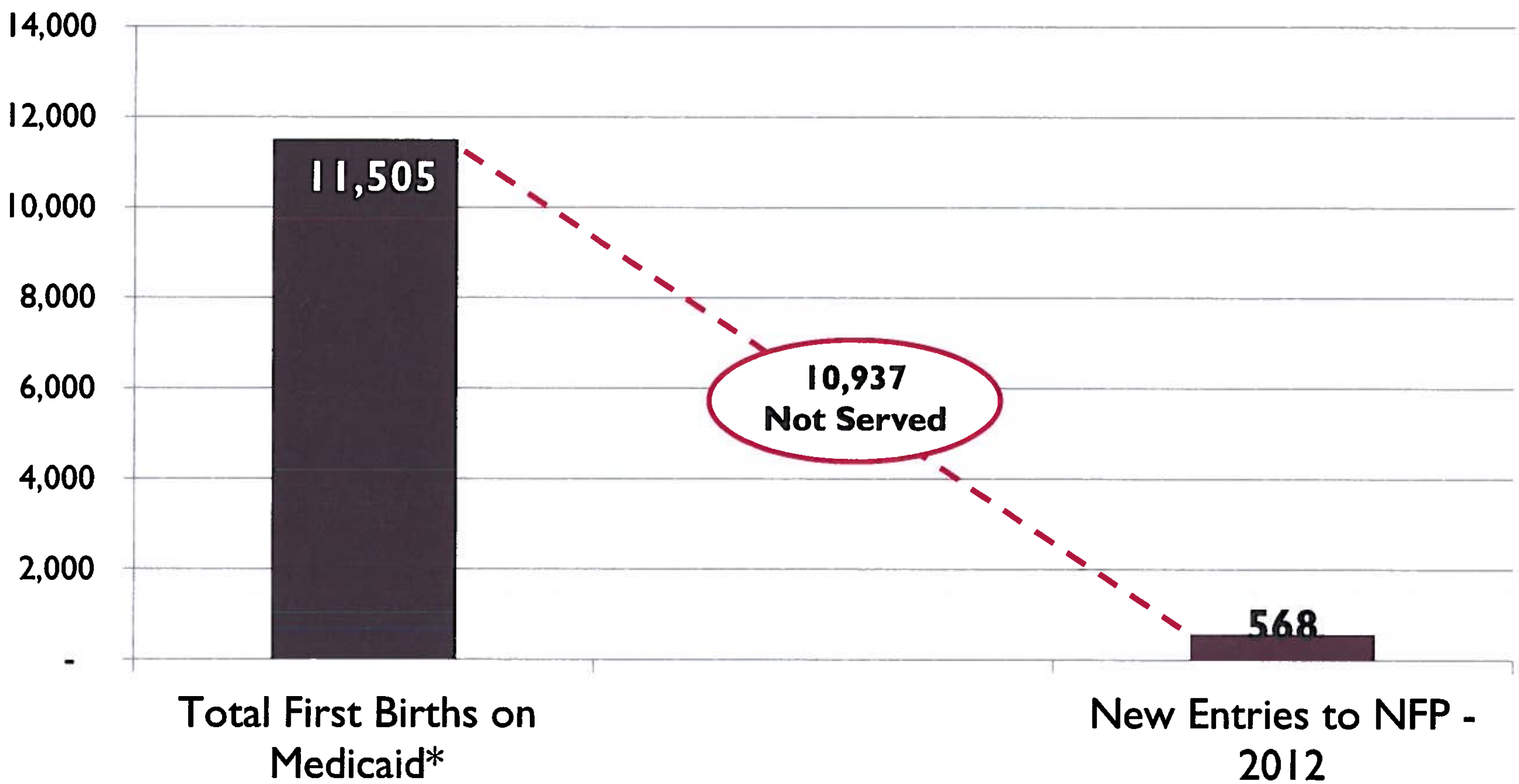
Government Savings More Than Cover Cost

- Cost of NFP = $7,754
- Government saves $19,120
- Medicaid saves $14,245
- Savings shared by state and federal governments



Source: *Miller, Cost Savings of Nurse-Family Partnership in South Carolina,* April 2013, p 1

Unmet Need for NFP in SC



Source: * *2011 Data; Michael G. Smith, SC DHEC, Bureau of MCH*
*** NFP State Nurse Consultant, South Carolina DHEC*

Proposed NFP Expansion Strategy

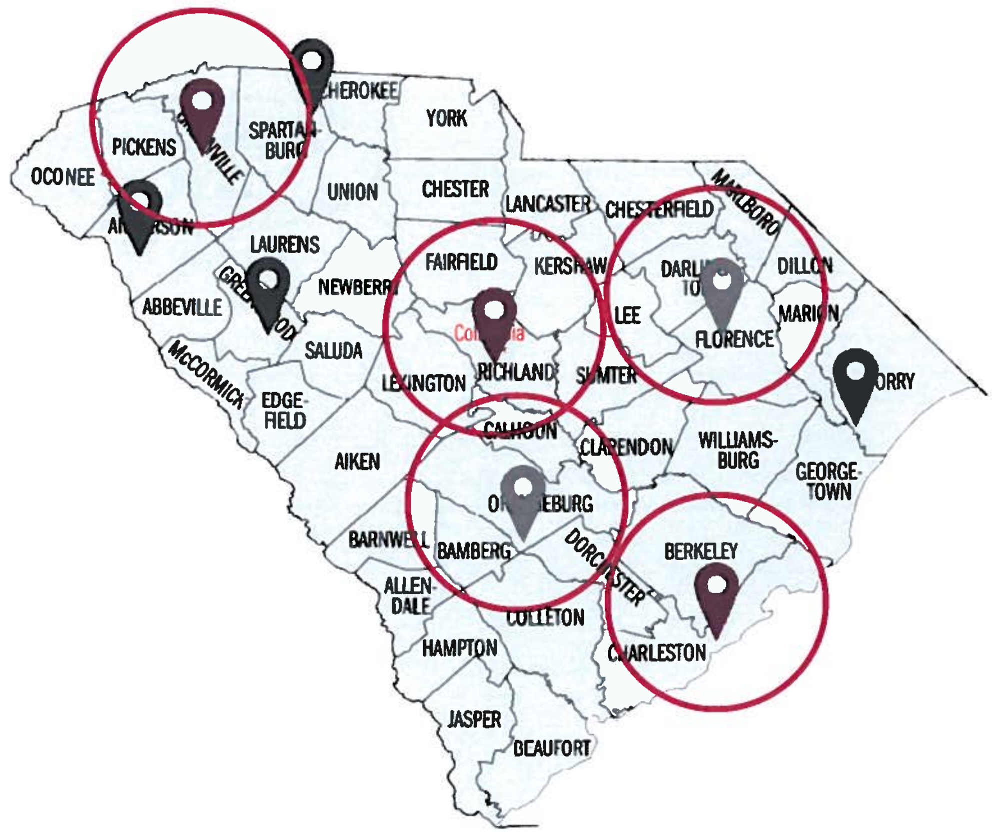
Increase Capacity in Areas with Largest Unmet Need

Expand three current locations:

- *Greenville*
- *Richland*
- *Charleston*

Add new location:

- *Orangeburg?*
- *Florence?*



Expected New NFP Clients

Region	First Births Paid by Medicaid*	Number Expected to Enroll in NFP per Year	Current Capacity**	Number of New Clients from Expansion
Greenville	1,548	387	94	293
Richland	1,793	448	79	369
Charleston	1,352	338	95	243
Orangeburg	477	119	-	119
Florence	1,153	288	-	288

x 25%

Total = 1,000 – 1,200 new families

Source: * *2009-2011 Averaged data; Michael G. Smith, SC DHEC, Bureau of MCH*
***2012 Data; NFP State Nurse Consultant, South Carolina DHEC*

Approximate Cost of Expansion

It will cost $8-9 million to provide NFP to 1,000 – 1,200 new high-risk families.

Number of New Clients
1,100
Average Cost of NFP per Family*
$ 7,754
Cost Over Length of Program for Each Cohort
$ 8,529,400

*Source: Average cost for full 2+ years of program services; *Miller, Cost Savings of Nurse-Family Partnership in South Carolina*, April 2013

Possible Health Outcomes for PFS Contract

- Fewer pre-term births
- Fewer infant deaths
- Fewer child emergency department visits
- Fewer closely spaced second births
- Fewer subsequent births
- Fewer subsequent preterm births
- Increase in children fully immunized

Possible Other Outcomes for PFS Contract

Child welfare

- Fewer incidences of child abuse or neglect

Education

- Fewer remedial school services through age 6

Criminal justice

- Fewer youth crimes through age 17

Maternal life-course

- Increased employment, decreased TANF use

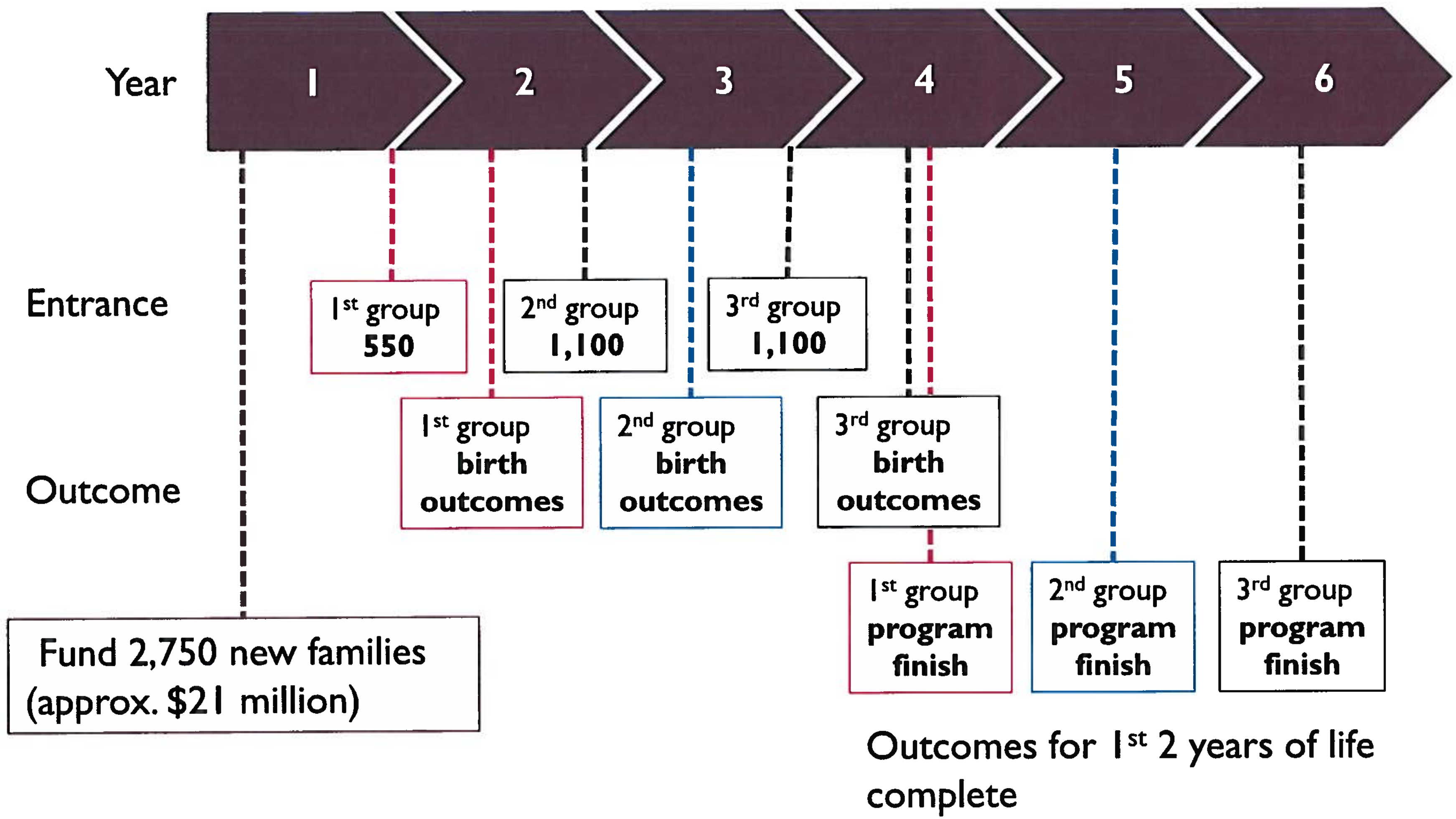
Proposal: Base PFS Contract on Health Outcomes

- Health outcomes happen relatively quickly (at birth or in first 2 years) => 4- or 6-year PFS
- Government interest in making more efficient use of Medicaid dollars

Most promising health outcomes:

- Reduce pre-term births
- Reduce emergency dept visits for injuries in first 2 yrs
- Improve spacing of second birth to lower risk

Possible PFS Timeline: Health Outcomes



Potential PFS Outcome: Fewer Pre-term Births

- S.C. is 47th in the country in pre-term births*
- In 2011, 11.2% of S.C. Medicaid-paid first births were pre-term**
- Costs include medical care, early intervention services, special education services, lost household and labor market productivity
- Analysis of U.S. evaluations and S.C. data shows NFP can reduce preterm births by 27%

Source: * *March of Dimes 2012 Preterm Birth Report Card*
** 2011 Data on live births less than 37 weeks of gestation; *Michael G. Smith, SC DHEC, Bureau of MCH*

Expected Pre-term Birth Reduction by Site

NFP can be expected to reduce pre-term births by **27.4%**

Region	Current Rate	Post-NFP Expansion Rate
Greenville	11.2%	8.1%
Richland	11.1%	8.1%
Charleston	10.9%	7.9%
Orangeburg	9.7%	7.0%
Florence	13.8%	10.0%

Possible PFS Contract Structure

- 2,750 new families, phased in over 3 years
- Pay for % reductions in 1 or 2 health outcomes compared to a control or matched comparison group
- Interim payments after each cohort (group entering NFP in 1 year) reaches outcomes
- 4-year or 6-year contract term

NYC Payment Terms, 4-Year Investment

Reduction in Reincarceration	City Payment to MDRC (Intermediary)
≥ 20.0%	$11,712,000
≥ 16.0%	$10,944,000
≥ 13.0%	$10,368,000
≥ 12.5%	$10,272,000
≥ 12.0%	$10,176,000
≥ 11.0%	$10,080,000
≥ 10.0%(breakeven)	$9,600,000
≥ 8.5%	$4,800,000

Source: *NYC Office of the Mayor, Bringing Social Impact Bonds to NYC, Media Presentation*, August 2012

Possible Financing Structures

- Several possibilities for mixing private, philanthropic & government financing to create a viable deal
- Tolerance for risk, required returns vary by funder type
- Government may need to make some non-outcome-based payments to limit down-side risk (i.e. risk that funders lose everything if outcome not achieved)
- The two largest intermediary organizations have prepared proposed structures to consider in Phase 2

SOCIAL FINANCE

Third Sector capital partners

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2014 State of the Nonprofit Sector Survey Results

April 2014

Learn more at http://nff.org/survey

Data is based on a nationwide survey of nonprofit leaders conducted by Nonprofit Finance Fund, January-February 2014

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Charting a New Path for Nonprofits

Nonprofit Finance Fund

- The economic recovery is leaving behind many nonprofits and communities in need
- Nonprofits face a dual challenge: meeting immediate demand, while simultaneously building new, more efficient systems for solving problems and creating positive change.
- There are clear opportunities to improve the current reality and build toward a better future.

"We are continually engaging in activities to improve our planning and to engage partners in collaborative planning to reduce the need for our emergency homeless shelter. All the while, of course, factors beyond our control are resulting in increased need (and cost) for our services. There will need to be substantive changes in public policy at the state and federal levels. That will require a level of leadership we do not see, especially at the state level."

-Human Services NPO, ME

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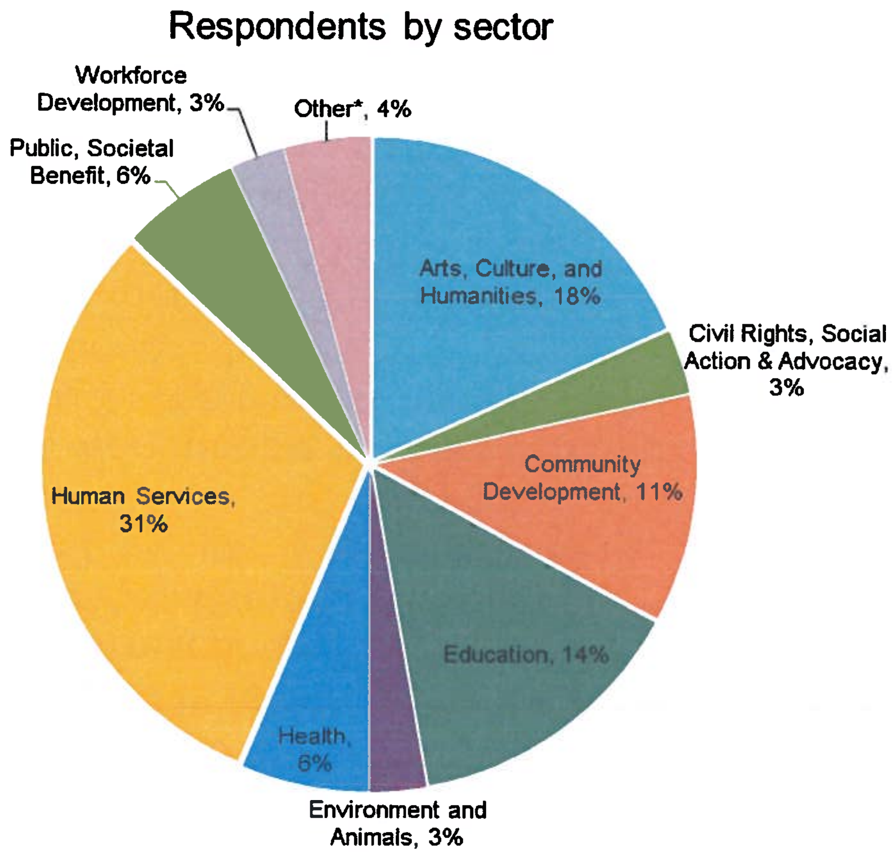
5019 Nonprofits Share Stories of Growing Demand, and the Need for Change

Nonprofit Finance Fund.



*Other includes Foundation, House of Worship, International/Foreign Affairs, Mutual/Membership Benefit, Unknown/Unclassified

"We provide Community Based Adult Services primarily to low income adults in a very poor area. The population is aging, concurrent with service cuts in related fields in our area, particularly in mental health programs. We are getting close to being the "last man standing" for a number of our participants. We see increasing needs, with more difficulty in getting people approved for services. Our funding contracts are primarily fee-for-service contracts through Medi-Cal and the VA."

-Healthcare NPO, CA

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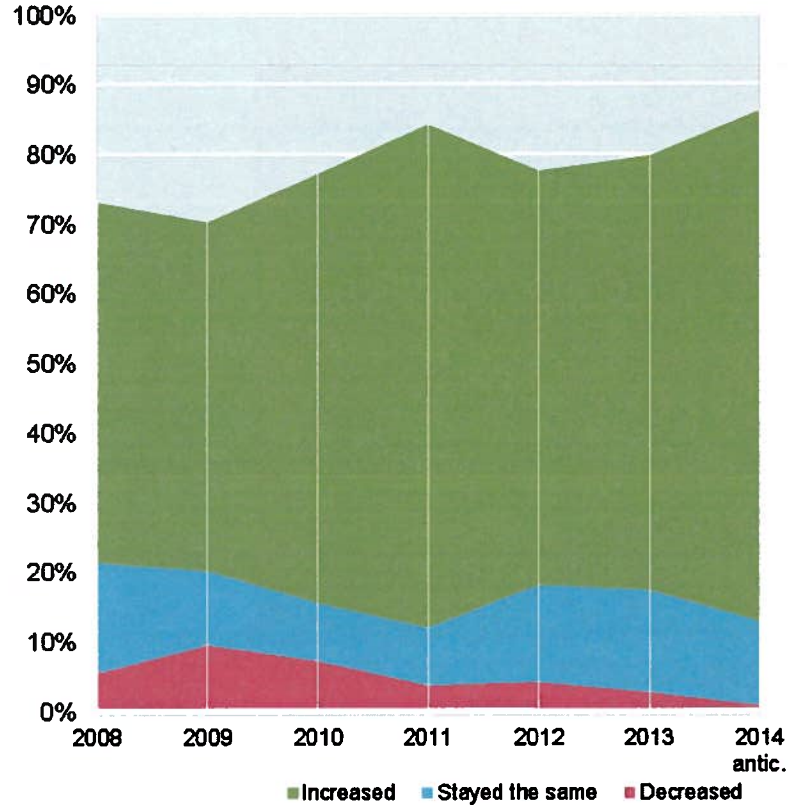
A Frayed Safety Net

Nonprofit Finance Fund.

The economic recovery is leaving behind many nonprofits and communities in need:

- 80% of respondents reported an increase in demand for services, the 6th straight year of increased demand
- 56% were unable to meet demand in 2013—the highest reported in the survey's history
- 86% expect demand to climb again in 2014, and 58% expect demand to go unmet
- Only 11% expect 2014 to be easier than 2013 for the people they serve

In comparison to previous year, respondents reported demand for services....



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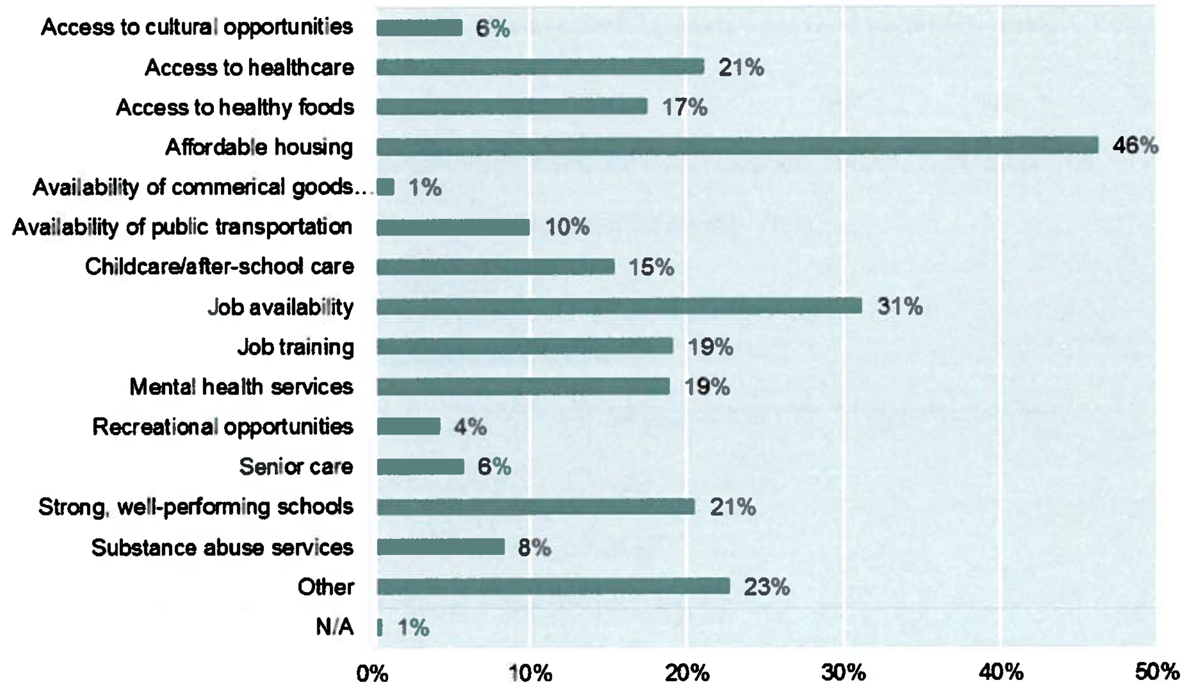
People Served by NPOs Have Unmet Needs-Especially in Low-Income Communities

Nonprofit Finance Fund.

- 70% of respondents serve vulnerable, low-income communities
- Jobs, affordable housing and education are primary concerns for those in low-income communities

Most critical community needs identified by NPOs serving low-income communities



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55% of Nonprofits Subsist with Three Months or Less Cash on Hand

Nonprofit Finance Fund.

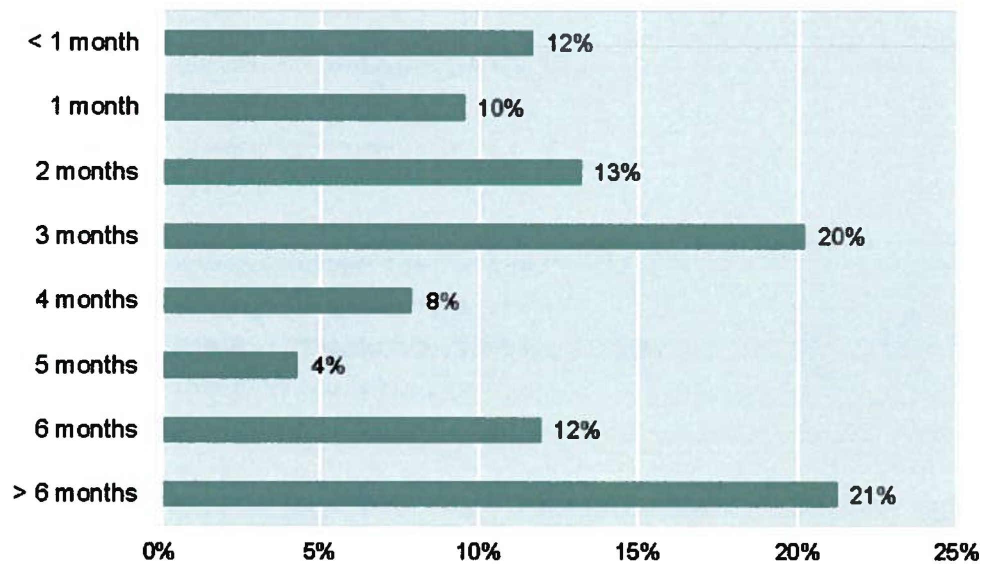
Financial results in 2013 were similar to the previous year:

- 28% of organizations had a deficit in 2013
- 31% broke even
- 40% had a surplus

However, surpluses were significantly smaller than deficits:

- Only 39% of NPOs reported surpluses of >5% of annual expenses
- By contrast, 47% of NPOs with losses reported deficits of >5% of annual expenses

How many months of cash are in reserves?



The less cash on hand, the greater the risk when revenue is late or unreliable.

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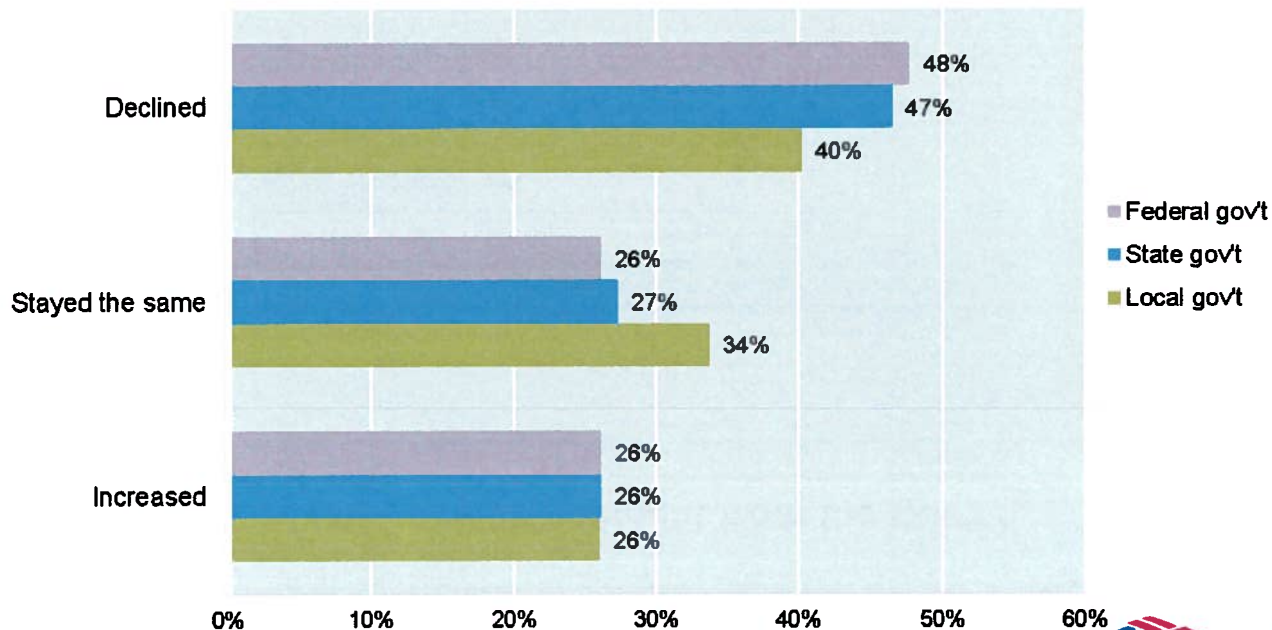
Government Funding, Critical to Many NPOs, Has Declined for Nearly Half

Nonprofit Finance Fund.

- 65% of respondents reported some gov't funding in 2014, down from 76% in 2013
- Almost half of these reported a 5-year decline in gov't funding

In the last 5 years, has your NPO's gov't funding declined, stayed the same, or increased?



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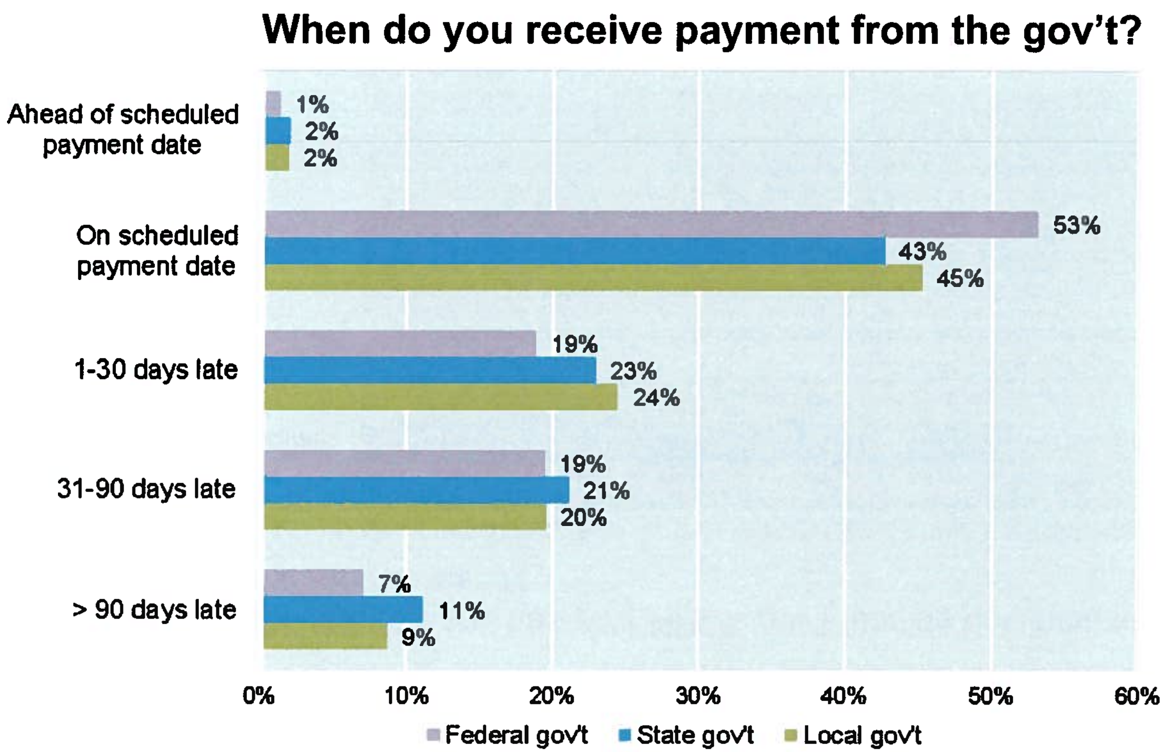
Government Payments Prove Unreliable; Nearly Half of Payments Are Late

Nonprofit Finance Fund.



"We have an internal working capital fund that we have built up to cover these sorts of delays and other cash flow needs."

-Civil Rights & Advocacy NPO, MD

- 37% use reserves to cover government payment delays
- NPOs without reserves delay vendor payments, borrow from staff or board members, or rely on other short-term strategies

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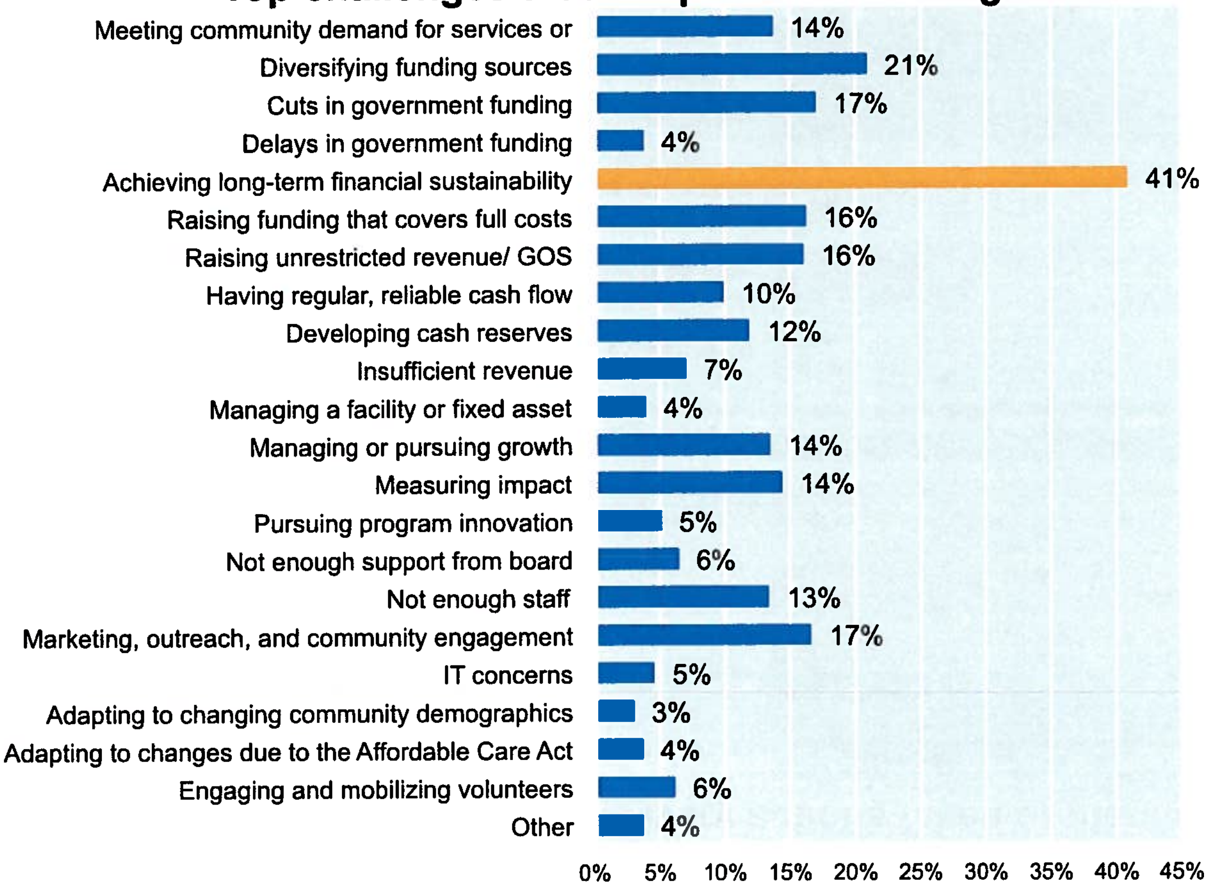
Organizations Are Balancing Current Service Demand with Long-Term Sustainability Issues

Nonprofit Finance Fund.

Top challenges that nonprofits are facing



What are the community implications if NPOs can't solve their long-term sustainability challenges?

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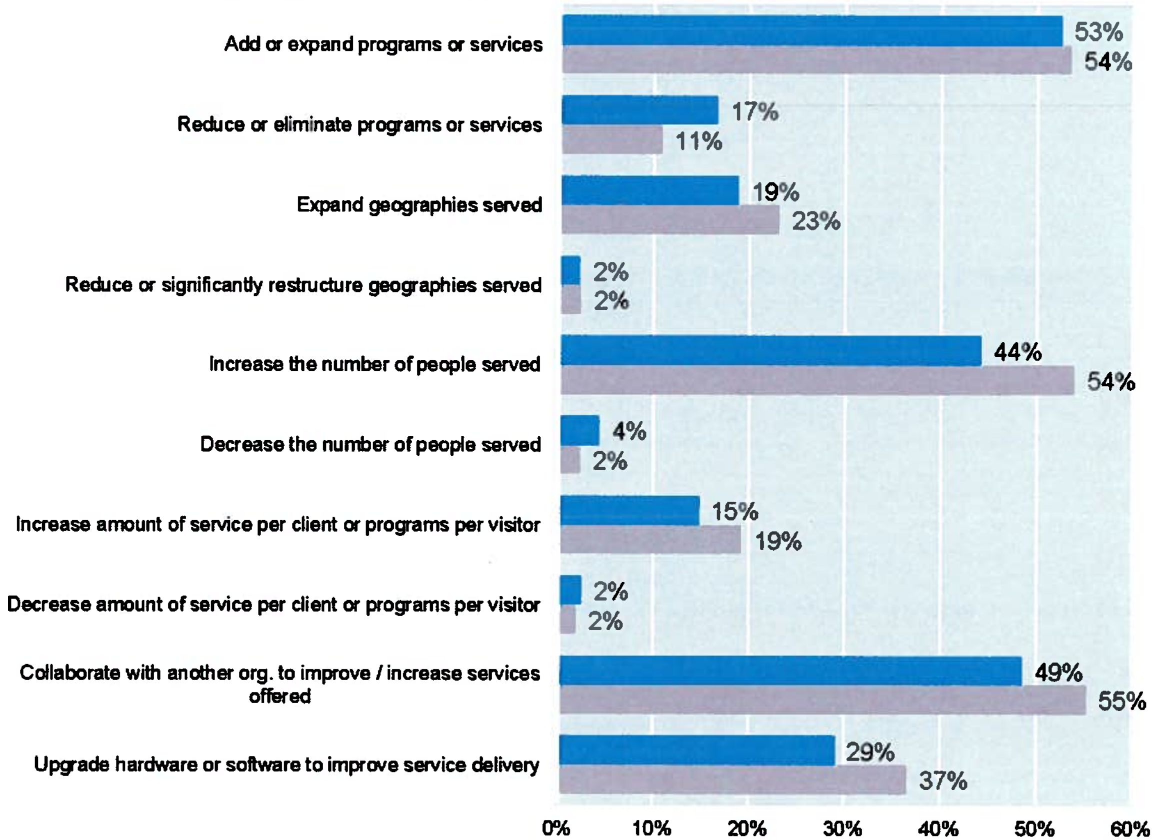
Even with Financial Challenges, NPOs Continue to Focus on Service Delivery

Nonprofit Finance Fund

Service delivery actions taken or planned



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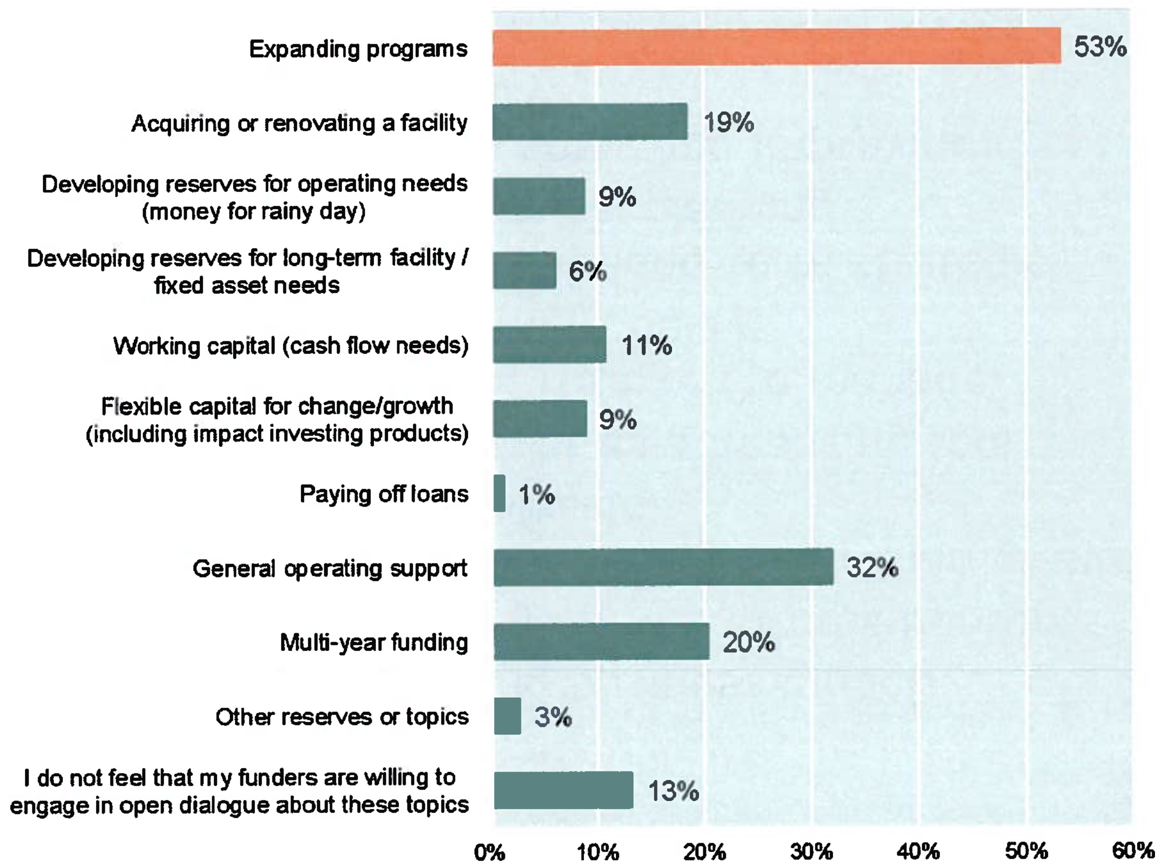
Are Funders and NPOs Discussing Financial and Operational Needs?

Nonprofit Finance Fund

"We offer homeless food and housing. Our clients can pay nothing. Annual operating funds are a constant challenge. Funders always want something new… and we need operating costs. That is just a fact. OR we need a for-profit or funder to help us/fund us to generate revenue so we can stop asking for operating funds. Neither option seems popular lately."
-Human services NPO, FL

My org can have open dialogue with funders about:



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Despite Lack of Systemic Funding Changes, Nonprofits Find New Approaches

Nonprofit Finance Fund.

"We are expanding our services a little bit by building a new low-income apartment building. Having done that, however, we are divesting our organization of older, more maintenance-demanding buildings. We need to either increase staff (which requires more funding) or scale back services to make the bottom line balance."
-Human Services, WA

Nonprofits are:

- Changing business models
- Pursuing earned income ventures
- Pursuing funding other than grants and contracts
- Using debt as a financing tool
- Building reserves to manage government delays
- Conducting long-term strategic and financial planning
- Cutting costs and improving efficiency
- Gathering data on what works

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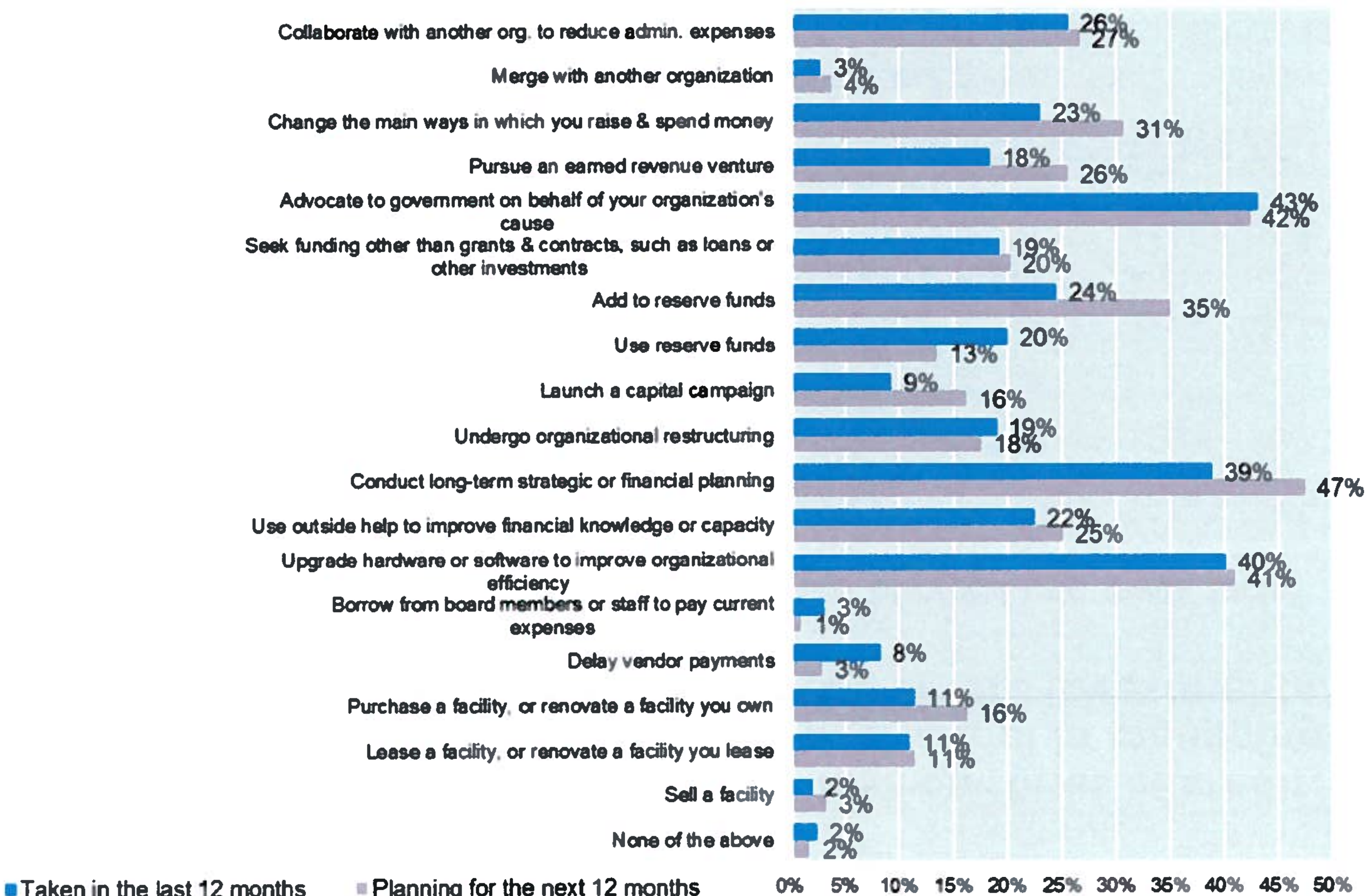
Respondents Take Strategic Actions toward Long-Term Health

Nonprofit Finance Fund

Mgmt. actions taken or planned in last /next 12 months



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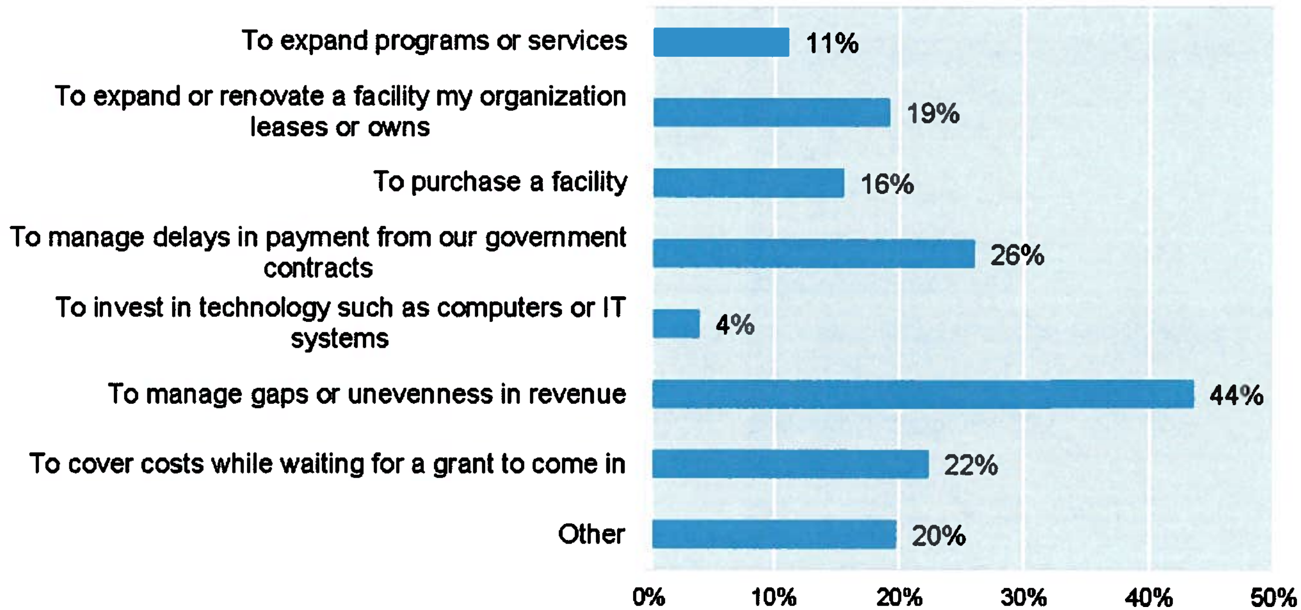
Some Explore Debt as a Financial Tool

Nonprofit Finance Fund

47% of respondents report using loans or lines of credit. When used wisely, debt can be a useful tool in managing growth, payment delays, and infrastructure investments.

How do NPOs with loans/lines of credit use these tools?



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NPOs and Funders Alike Seek Meaningful Data on What Works

Nonprofit Finance Fund.

- 70% of respondents reported that half or more of their funders request impact metrics for grant reports
- 77% agreed that the metrics funders ask for are helpful in assessing impact.
- Only 1% reported that funders always cover the costs of impact measurement; 71% said costs were rarely or never covered.
- Nonprofits that don't collect impact data often said it is because they lack the staff, time or resources to secure training or outside help.

"Nonprofits need to be visible in the communities they serve. Many nonprofits are only heard from when asking for support. The community needs to know that the nonprofit is a part of the [whole] community, the good it does, the care with which its leaders use the community's resources and the impact it makes in meeting the needs of the community. A community will support a nonprofit with time, talent and treasure IF the impact the nonprofit is making is known and appreciated..."

-Public, Societal Benefit NPO, PA

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Supporting the Present and Building for the Future

Nonprofit Finance Fund

Despite urgently needed systemic change to the way NPOs are funded, nonprofits continue to survive, innovate and serve our communities. But there are clear opportunities to improve the current reality and build toward a better future.

Funders can invest in helping nonprofits address top challenges such as:

- Planning for long-term financial sustainability
- Diversifying funding sources
- Marketing and community engagement
- Raising unrestricted funds

Funders and nonprofits can work together towards:

- Improved communication: Many NPOs aren't comfortable speaking with funders about critical needs and financial realities
- Better understanding of needs: NPOs and their funders should understand the full costs of providing services; funders should either cover them or work with grantees to create a plan for closing the gap

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Supporting the Present and Building for the Future

Nonprofit Finance Fund

"We put in an operating reserve 2 years ago that is serving us well. It allows us to set and maintain budget goals. Also we are developing a decision making tool that analyzes not only long-term sustainability, but mission impact. It has really allowed us to begin the process to define our impact which we believe is what funders and donors want."

-Human Services NPO, IL

"When faced with drastic (or otherwise) reductions in funding from the least controllable sources (i.e. government, United Way), we used the opportunity to focus our energies on shifting our reliance from "risky" funding to the more reliable sources that we have more control over. This resulted in the development of strategies to dramatically increase individual giving both currently (annual fund, major gifts) and in the long run for sustainability (endowment). The crisis served as a catalyst and a terrific case for change. So our advice is to turn crisis into opportunity and to rely as much as possible on sources you have the most control over."

-Education/Youth Development NPO, NH

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