



An introduction to Social Impact Bonds

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The launch of the Sustainable Development Goals (SDGs) by the United Nations in 2016 has brought the world together in a mission to end poverty, fight inequality, and tackle climate change. Meanwhile, a bond market aimed at financing projects with social issues has emerged and deepened, supported by a growing number of investors who have begun to embed ESG (Environmental, Social, and Governance) standards into their investment decisions.

A social impact bond is one potential financing option available to support Pay for Success programs. Social Impact Bonds brings together government, service providers and investors to implement existing and proven programs designed to accomplish clearly defined outcomes. Investors/funders provide the initial capital support and the government agrees to make payments to the program only when outcomes are achieved. So government pays for success. A social bond (SIB) is a contract with the public sector or governing authority, whereby it pays for better social outcomes in certain areas and passes on part of the savings achieved to investors. A Social impact bond, also known as Pay for Success Financing is a contract with the public sector in which a commitment is made to pay for improved social outcomes that result in public sector savings. The term was originally coined by Geoff Mulgan, Chief Executive of the Young Foundation. The first Social Impact Bond was launched by UK-based Social Finance Ltd. in September 2010.

Social Impact Bonds are a type of bond, but not the most common type. While they operate over a fixed period of time, they do not offer a fixed rate of return. Repayment to investors is contingent upon specified social outcomes being achieved. Therefore, in terms of investment risk, Social impact bonds are more similar to that of a structured product or an equity investment. The idea of the Social impact bond has been promoted and developed by a number of agencies and individuals in an attempt to address the paradox that investing in prevention of social and health problems saves the public sector money, but that it is currently difficult for public bodies to find the funds and incentives to do so.

The design of a SIB can be articulated in 6 steps

- Form a public-private partnership on a priority subject area. The Government defines in the first instance the desired social or environmental outcomes to be prioritized. It usually works with the intermediary, service provider(s) and forerunner investors to conduct pre-feasibility assessments.
- Develop a detailed project and outcome metric. The intermediary works with the Government and the service provider(s) to design a payment for success metric, i.e. the metric for which payments will be released by the Government to the investors. Simplicity and manageable costs of measurement are key considerations. The intermediary usually drives the design, negotiation, and structuring phases.
- Mobilize capital. The intermediary raises capital from impact investors and from philanthropy to provide upfront funding to the service provider in order to execute the project. The intermediary might also engage third parties in order to offer a partial guarantee to investors.
- Deliver services. The service provider executes the project. The intermediary is responsible for oversight, performance management, course corrections, financial management and investor relations.
- Validate outcomes. An independent evaluator measures the outcomes achieved by the project on the basis of the predetermined metric. The project might or might not achieve its stated outcomes.
- Release of payments. When successful and based on the evaluation's results, the Government repays the upfront capital plus an interest. If the project does not achieve its outcomes, there is no payment.

How does it work and what are the objectives

The Social Impact Bond (SIB) is a public-private partnership where one or more investor(s) provide "upfront" capital for the realization of public projects that generate verifiable social and/or environmental outcomes. Under a typical model, the Government contracts an intermediary (or project sponsor) to implement a social/environmental project in exchange for a promise of a payment contingent on the social outcomes delivered by the project. The intermediary will raise the capital for the project-hence use of the term bond-from commercial and/or philanthropic investors. It will then contract a service provider to deliver the project's outcomes. If

the project fails to deliver, the Government does not pay and the investors will lose part or all of their capital. If the project is successful, the Government pays the intermediary and investors. The objective is to:

- Align impact investment with measurable social and environmental outcomes;
- Grant affordable access to capital to public projects, particularly for preventive and conservation measures;
- Provide greater certainty on revenues for the execution of public projects due to the frontloading of all required resources; and
- Introduce rigorous approaches to performance management by closely linking payments with performance-refocusing the social sector on outcomes and ensuring public resources are well spent.

What are the main risks and challenges?

Pros

- For government, the SIB can reduce or minimize the financial and operational risk while promoting investment in social / environmental projects.
- For investors, the SIB offers a "mission-aligned" investment opportunity, as well as a potential return on investment.
- For service providers, the SIB offers access to upfront funding for the delivery of the services.
- For project execution, the SIB helps to introduce results-based management practices. Investment rigor can help to achieve higher standards in design and delivery
- As a movement, it highlights the importance of achieving outcomes instead of focusing solely on the use of inputs.
- It creates space and a working modality for public-private partnerships and collaborations.

Cons

- Requires verifiable quantitative metrics, which are difficult to derive for a number of projects
- Comparatively complex and time-consuming to set up. When the metrics get established and awareness is raised, the costs of developing a SIB will be gradually reduced.
- The intricate structure of negotiations, coordination and implementation generate comparatively high administrative costs.

Risks

- If the outcomes are not achieved, the investors will lose their investment. The SIB is indeed a risk sharing mechanism where the Government transfers the risk of project execution to private investors.
- Investors may demand and lobby for lower "success thresholds" so that they are sure to be repaid.
- Profit as incentives for investors may compromise social impact in exchange for greater revenues or lesser risks. Trade-offs exist in terms of the need to attract investors versus achieving more ambitious goals and among investors
- The misuse of SIB labeling can damage the reputation of the instrument and the trust of the impact investment community.

Improving effectiveness of SIB

The structure and incentive-system of SIBs is designed to favor the financing of projects with high social and environmental impacts. The following considerations could be taken into account to improve their impact and scale:

- Pursue economies of scale. Since many projects financed by SIBs are relatively small, continued philanthropic support is likely to be required, particularly in meeting the sunk costs of intermediation, such as the development of outcome matrices. However, if the market reaches a sufficient size these resources could be freed again for grant making activities. The establishment of funds dedicated to SIBs can accelerate this process.
- Balance between projects that are innovative and projects that have a larger impact.
- Clear identification of target beneficiaries can help simplifying the outcome metric and delivering more focused and impactful interventions.
- Reinforce the link between returns on investment and impact, including top-up payments for exceptional results. The Government should consider scaling up the original contracts that successfully delivered on outcomes. This option would increase the incentive of investors and service providers to deliver better.
- Ensure that the payments directly relate to the intended outcome (and include a longer-term outcome evaluation). This includes ensuring that the right metrics are in place to reward genuinely better outcomes.
- Learn from implementation and share lessons, including the identification of what drives better outcomes.