

SOCIAL IMPACT BONDS

OPPORTUNITIES AND NEXT STEPS

PREPARED FOR: **CHILDREN'S GROUND**

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EXECUTIVE SUMMARY

Social Impact Bonds (SIBs) have generated significant interest among social policy-makers and service-deliverers alike for their potential to provide a stream of long-term funding to match the resource needs of long-term, preventative projects (Disley *et al.* 2011; Liebman 2011; Social Finance 2011; McKinsey & Company 2012; Third Sector Capital Partners 2013). This report provides a brief review of the theory, experiences to date and suggested next steps for Children's Ground to capture the SIB opportunity.

WHAT ARE 'SOCIAL IMPACT BONDS'?

Social Impact Bonds (SIBs) are a financial instrument that links private capital with social service providers (Disley *et al.* 2011; Liebman 2011; Social Finance 2011; McKinsey & Company 2012). SIBs are a form of 'pay for success' or 'pay by results' (PBR) funding mechanism (Disley *et al.* 2011; Social Finance 2011; McKinsey & Company 2012; Third Sector Capital Partners 2013). Similarly to other PBR mechanisms, the design of SIBs incorporates incentives to maximise the social benefits from the sought-after outcomes. However, there are significant differences between SIBs and other funding mechanisms. These differences provide important benefits but also introduce additional complexity for the design of SIBs. In this section, we will highlight the salient features.

Figure 0-1 outlines how the basic SIB design works. There are several parties to a SIB transaction. There are three key parties that have a direct influence on the success of a SIB transaction. First, there is **government** that is looking to engage external social service deliverers. Government does not provide upfront capital, but is liable for performance payments should the service provider meets or exceeds the agreed outcome metric (Social Finance 2011; McKinsey & Company 2012).

The second key party is the '**intermediary**' (to adopt McKinsey's terminology). The intermediary is essentially a 'project manager' that manages all the relationships and the day-to-day operation of the service delivery. However, the intermediary is *not* the service provider. The intermediary manages the performance of the service provider and has the ability hire and fire service providers. The intermediary has both a fixed and performance-based compensation scheme (McKinsey & Company 2012): the fixed component compensates the intermediary for the ongoing project management services while the performance-based component aligns the intermediary's objectives with delivering on the social outcomes specified in the SIB outcome metrics.

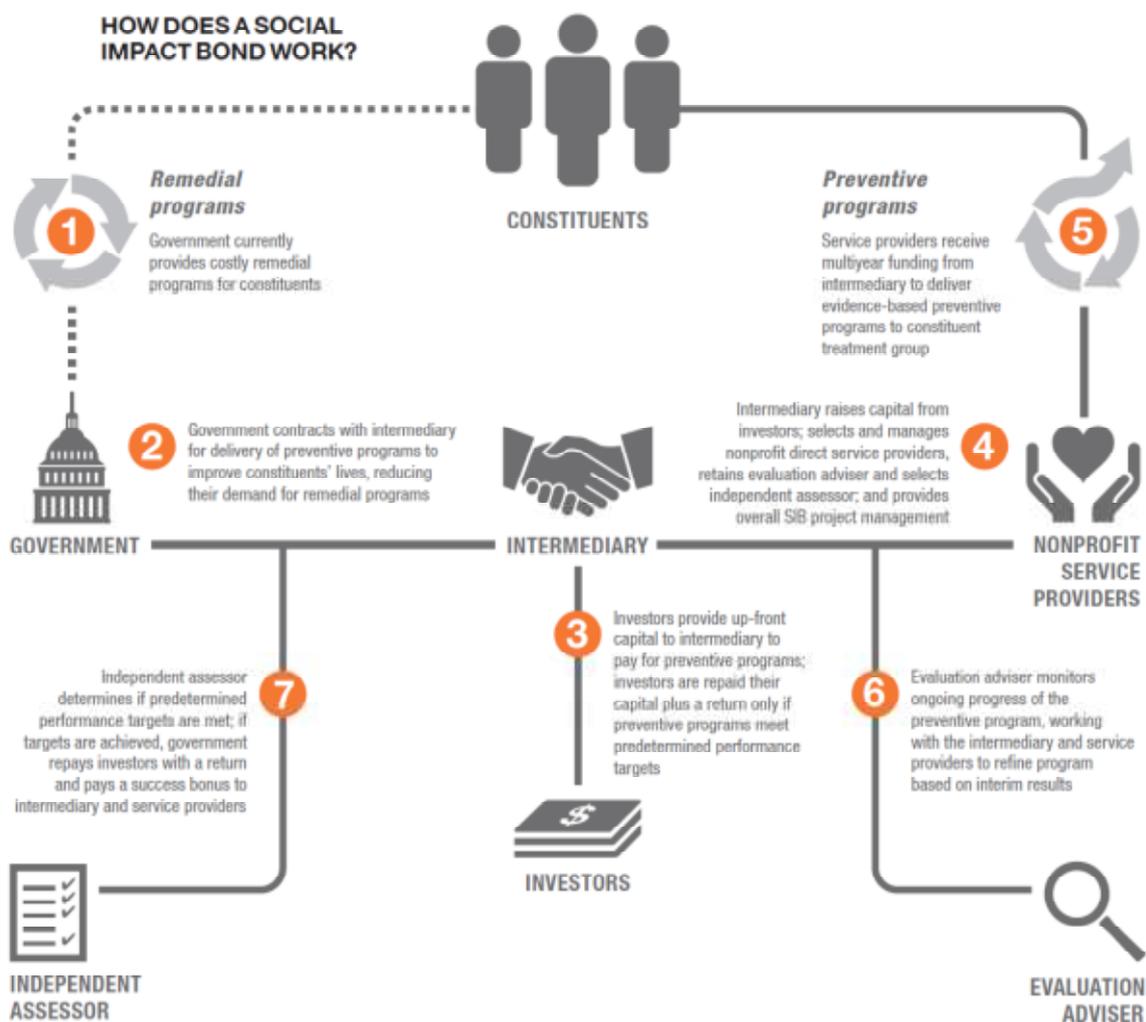
The third key party are the **investors** in the SIB. These investors provide the up-front working capital that enable the intermediary to contract service providers to work towards delivering the sought-after social outcomes (Disley *et al.* 2011; Liebman 2011; Social Finance 2011; McKinsey & Company 2012; Third Sector Capital Partners 2013). Investors are encouraged to participate in SIBs with the potential to earn above-market returns. Above-market returns are paid to investors if the intermediary is successful in delivering the social outcomes as specified by the outcome metric.

The other players in a SIB transaction as illustrated by Figure 0-1 are the independent assessor, evaluation adviser, the nonprofit service providers and constituents. These players have less direct influence on the structuring of the SIB but have a critical impact on the success of the SIB as a tool for

improving social outcome. The **service provider** is the agent that actually delivers the program on a day-to-day basis. The SIB is structured to ensure that the service provider can focus on service delivery. Service providers are paid on a fixed basis without a performance component (Disley *et al.* 2011; McKinsey & Company 2012).

Both the independent assessor and evaluation adviser are both evaluation specialists but have distinctive roles (McKinsey & Company 2012). The **independent assessor** has a key role in determining if the service provider achieved the sought-after outcome and if the investors and intermediary are entitled to performance payments. The independent assessor reports to government rather than the intermediary in order to maintain objectivity. They do not have a role in the performance or design of the SIB.

Figure O-1



Glossary of terms

Remedial services: Government programs that address negative social outcomes after they've occurred (e.g., incarceration for criminals, emergency room access for the chronically homeless).

Preventive interventions: Social service programs that focus on avoiding negative social outcomes (e.g., alternatives to incarceration, permanent supportive housing for the chronically homeless).

Constituent treatment group: Those individuals who benefit from the preventive intervention and whose results are compared to others who did not receive similar services.

Source: McKinsey and Company (2012).

On the other hand, the **evaluation adviser's** role is to monitor the progress of the project and to provide advice on how to improve service delivery in order to achieve the desired social outcome (McKinsey & Company 2012). The role of the evaluation adviser is crucial given the evidence-based nature of the outcome metric (Disley *et al.* 2011; Liebman 2011; McKinsey & Company 2012; Third Sector Capital Partners 2013). The ongoing flow of evaluation information allows the intermediary to adjust the project in order to maximise success of achieving improved social outcomes.

Finally, **constituents** are the direct beneficiaries of the delivery of social programs financed by a SIB. Most social programs would require the active participation of the target population in order to achieve the desired social outcome.

ADVANTAGES OF SIBS

Improved Funding Arrangements for Governments and Service Providers

Governments do not provide up-front working capital for SIBs, instead this is provided by private investors. Both investors and the intermediary are paid performance payments should the program deliver the desired social outcomes by the government. Theoretically, the government should be able to afford the performance payments if the improved social outcomes are delivered because this is correlated with lower government spending on remedial programs (Disley *et al.* 2011; Social Finance 2011; McKinsey & Company 2012).

Incentive Alignment

SIBs are designed to align the incentives of the key players (government, intermediary and investors) with achieving the desired social outcome. The desired social outcome is expressed as a metric that is agreed between government and the intermediary when structuring the SIB (Disley *et al.* 2011). Performance payments are made if the outcome metric are met or exceeded. Performance payments are used to encourage investors to provide up-front capital with the potential of receiving above-market returns. With the intermediary, the performance payment is more directly linked to service delivery because they are responsible for the delivery of the social program.

Risk Transfer

SIBs provides a means to transfer the risk of delivering a program to private investors (Liebman 2011; McKinsey & Company 2012). The private investors are exposed to delivery risk because they have provided the upfront capital. Government only pays if the program is successful in delivering the desired outcomes.

Innovation

Using SIBs may allow governments to 'scale up' innovative and promising social programs (Liebman 2011; McKinsey & Company 2012).

Preventative Programs

SIBs could enable governments to shift away from remedial (after the fact) activities to preventative activities (Disley *et al.* 2011; Liebman 2011; Social Finance 2011; McKinsey & Company 2012; Third Sector Capital Partners 2013).

Long-Term Impacts

In theory, SIBs can be structured to be as long as 10 years (Liebman 2011). This would have the benefit of providing financing to tackle difficult social problems over a suitable time frame. However, investors are unlikely to tolerate such long time frames before they are repaid their principal (Disley *et al.* 2011; McKinsey & Company 2012). McKinsey and Company (2012) suggest five years may be a more appropriate time frame for a SIB.

Improved Accountability

The use of ongoing evaluation, outcome metrics and an independent assessor would improve transparency (Disley *et al.* 2011; Liebman 2011; McKinsey & Company 2012). This may encourage governments to look to replace existing programs that cannot demonstrate improving social outcomes, or at the least encourage agencies to collect data to determine program effectiveness (Liebman 2011).

CHALLENGES

Requires Intensive Multi-disciplinary Approach to Successfully Develop

The development of SIBs requires a multidisciplinary approach to successfully structure (Disley *et al.* 2011). Expertise from law, government, statistics, social service, finance, project management, evaluation and 'soft skills' are required to successfully develop a SIB.

Perverse Incentives

There are several ways to undermine incentives if the outcome metric is poorly defined. First, the outcome metric may not be correlated with the actual desired social outcome (Liebman 2011). Secondly, if the target group is poorly defined in the counterfactual (i.e. 'business as usual') the metric may provide a distorted view of the outcome (Liebman 2011).

Complexities of Government Relationships

The sponsoring agency may not be the agency that receives the budgetary savings. This could result in an insufficient performance payment to entice potential investors and intermediaries to participate in the SIB. At worse, it could prevent the SIB from proceeding. The Australian Federal system adds a further dimension of complexity because of overlapping responsibilities in social policy. A thorough understanding of which agencies at Federal, State and maybe local level would be necessary to include all the relevant agencies that have an interest in savings from the SIB program.

Mismatched Timeframes

A serious design issue is the mismatched time frames between the time required to improve social outcomes and investors' preferences (Disley *et al.* 2011; Liebman 2011; McKinsey & Company 2012). A SIB program that ends before outcomes can be fully achieved could result in reversals of the gains or even harm to the target populations (Disley *et al.* 2011; McKinsey & Company 2012; Third Sector Capital Partners 2013).

EXPERIENCE SO FAR

HMP Peterborough, UK

The HMP (Her Majesty's Prison) Peterborough SIB is the world's first SIB (Disley *et al.* 2011). The program was focused on reducing recidivism of prisoners discharged from short-term sentences (12 months or less) from HMP Peterborough in three cohorts.

The Peterborough SIB highlighted that government procurement and accounting processes are not ready for SIBs. Unless there is a committed champion within government that is willing to take risks, invest in building support and think creatively to push SIBs, it is unlikely SIBs will become a reality. Identifying a champion, at a senior level, or a policy driver for SIBs is crucial to ensure the development of SIBs.

Another key lesson of the Peterborough SIB is the importance of data analysis for the development of a SIB. However, there has been a general trend in government agencies to cut back on 'luxuries' such as analytical expertise and contract consultants. Furthermore, many agencies have also reduced spending on data collection.

Massachusetts Recidivism Reduction, USA

When the Commonwealth of Massachusetts called for proposals to reduce recidivism, the request asked for PBR proposals rather than specified it was a call for SIBs (Third Sector Capital Partners 2013). However, they would welcome a SIB proposal if one was put forward. The request did not specify outcome metric or payment structure, this was left to the proponents' to specify. A key lesson for competitive tenders for SIBs is the resource-intensive nature of responding to a request. Preparing for such an opportunity would involve building relationships with possible partners and experts in legal, finance, statistics and social policy that could assist with a proposal. Also, having sufficient working capital to fund a lengthy preparation would be beneficial.

The structure of the Massachusetts SIB is similar to a 'Collateralised Debt Obligation' (CDO) that were commonly used to package mortgages and then on-sold to investors. The advantage of a CDO structure for SIBs is that it provides a way of accessing profit-seeking as well as philanthropic funds. This structure has the potential to access broader investment pool than the Peterborough SIB because of the layers (or 'tranches' in financial jargon) of protection given to profit-seeking investors. While it appears the third tranche is not being used for working capital, it has an important enabling

function in reducing the risk for other investors and would allow this SIB to access a broader investment pool than would otherwise be possible.

Rikers Island, New York USA

The Rikers Island SIB is similar to the HMP Peterborough SIB in that it finances recidivism reduction in a prison (i.e. Rikers Island) (The City of New York Office of the Mayor 2012). It was the first SIB in the US and was structured by the investment bank, Goldman Sachs (Olson and Phillips 2013). The key lessons from this SIB is in how it has been structured.

The Rikers Island structure is interesting because of the design of the guarantees as a risk-mitigant and potential performance payment for the intermediary. As a risk-mitigant, the guarantee enables Goldman Sachs to provide financing to a project with essentially unknown risk. As an incentive, MDRC (the intermediary) has a strong financial incentive to succeed because it could receive \$7.2 million at the end of the SIB.

Newpin Social Benefit Bond, New South Wales, Australia

The Newpin Social Benefit Bond is a \$7 million program with a seven years term (Social Ventures Australia undated). The outcome metric is the restoration of children to their families' care (New South Wales Treasury undated). This outcome, unlike the Peterborough SIB is determined independently by the NSW Children's Court. Therefore, it avoids many of the analytical demands that the recidivism reduction SIBs required.

Given the relatively high return and the credit-enhancements, Newpin appeared to be an attractive value proposition to investors because it was fully subscribed (Social Ventures Australia undated). Furthermore, from Figure 6-1, we can see that Newpin target restoration rate is 65%, presumably per year. No information was given on how this was calculated or what the relevant counterfactual was. According to Social Ventures Australia (undated), Newpin has historically achieved a restoration rate of 74.5%. If this performance continues, investors in Newpin SBB may receive 15% return per year. Given all these factors, it is clear that the expected return and the credit enhancements makes this a very attractive investment.

RELATIONSHIP WITH SROI

The information required to develop a SIB is similar to what is needed to complete a Social Return on Investment (SROI) study. Both require rigorous estimation of the benefits and costs of an activity. Both require thinking intensively about the relevant counterfactual and estimating the genuine improvement attributable to a social policy program. It is true SROIs are broader than SIBs by incorporating environmental benefits and costs (The SROI Network 2012). Nevertheless, there is significant overlap that can be exploited to reduce the costs of doing a SROI or SIB individually.

Conducting SROI studies as a normal course of operation can help a service provider prepare for a SIB opportunity be first, demonstrating performance and, secondly, establishing the data collection systems required to successfully implement a SIB.

NEXT STEPS FOR CHILDREN'S GROUND

If Children's Ground are considering SIBs as a potential source of capital, it would need to be able to demonstrate to government, investor, intermediary and other partners that it has an operational model that is a viable proposition for SIB financing. Children's Ground would need to demonstrate the social and financial benefits of its approach. In addition, Children's Ground would also need to demonstrate it has the operational model to deliver and the monitoring and evaluation systems that can credibly track progress. For Children's Ground to demonstrate it has a viable proposition to exploit a SIB opportunity, I advise the organisation to take the following steps.

Step 1: Establish Baseline Dataset

For Children's Ground to successfully design and market a SIB, evidence is required to demonstrate the proposed program would have a genuine social improvement. This means the collection of an appropriate baseline dataset is crucial for convincing potential investors that the organisation has an operational model that delivers results. This task should be given priority given that Children's Ground has already commenced implementing its collaborative model. A useful first step is to determine what type of variables does Children's Ground want to influence. These variables should be explicitly linked to the objectives of the collaborative model. When the variables of interest have been determined, the next step could be to determine what type of data was collected before the implementation of the Children's Ground collaborative model. This data could be used to determine the baseline from which net social impact can be measured.

Step 2a: Implement Monitoring and Evaluation System

The second part of determining if Children's Ground is producing a genuine social impact is to implement a monitoring and evaluation system that can collect and store impact data generated from the delivery of services. The monitoring and evaluation data should be based on the variables of interest that has been determined in Step 1 in order to determine if there has been a genuine social improvement. Given the greater availability of portable tablets or smart phones, these technologies can be used to collect the data as part of the ongoing operation of Children's Ground collaborative model. The incorporation of such technologies can also have a beneficial effect of developing a culture of monitoring and evaluation throughout the organisation. Furthermore, incorporating a user-friendly method of reporting progress would allow Children's Ground to keep key stakeholders informed of progress as well as demonstrate that it has the data management systems in place to rigorously demonstrate impact as a part of a SIB program.

Step 2b: Undertake SROI

As discussed in chapter 7, developing a SROI has complementarities with a SIB. The SROI could have an explicit secondary goal of analysing the financial feasibility of a SIB. For example, the SROI could be used to identify the public agencies that would benefit from a potential SIB-funded program and calculate the potential budget savings. The SROI could then provide a preliminary analysis on the benefits and budget savings to government from a SIB-financed program.

Because of the dual goals of a SROI study for Children's Ground, the SROI would be ideally undertaken by service providers who have experience in both SROIs and SIBs. Social Ventures Australia is a good

example that has experiences in both SROIs and SIBs. This step can be done concurrently with Step 2a assuming it is undertaken by an external service provider.

Step 3: Develop a SIB Proposal

The results from steps 2a and 2b would provide sufficient information to determine if a SIB was feasible. The results from ongoing monitoring and evaluation would provide important information on the effectiveness of Children's Ground collaborative model. This information can be used in SIB development to determine the trigger for performance payments. The SROI will provide information to potential government and investment partners on what kind of social and financial returns would be possible. This information can be used to design and model cost and returns for investors.

These two pieces of information can be used as the core content of a 'road show' to potential intermediary, government and investment partners to demonstrate the social and financial returns from the proposed SIB. Using data that was produced by robust monitoring and evaluation systems and obtaining certification on the credibility of the data (e.g. expert review) would provide assurance to government and investors that Children's Ground has been delivering genuine social impact and would be a reasonable investment proposition. Furthermore, the SROI report from a certified SROI practitioner (e.g. Social Ventures Australia) would also provide evidence to government and investor stakeholders on the merits of the proposal.

If there is strong interest from government and investors generated from the SIB 'road show', Children's Ground could develop a more formal proposal. This could be done as a result of responding to a formal tender request by key government stakeholders (e.g. at Ministerial or department head level) championing the use of SIBs. The proposal should be undertaken by the intermediary since they would have to develop the necessary social, financial and relationship knowledge to successfully manage the SIB. Some of this knowledge could be developed through developing the SROI. However, more specific information, such as the details of the performance metric, will have to be developed as part of the SIB proposal.

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1 INTRODUCTION AND SCOPE

Social Impact Bonds (SIBs) have generated significant interest among social policy-makers and service-deliverers alike for their potential to provide a stream of long-term funding to match the resource needs of long-term, preventative projects (Disley *et al.* 2011; Liebman 2011; Social Finance 2011; McKinsey & Company 2012; Third Sector Capital Partners 2013). This report provides a brief review of the theory, experiences to date and suggested next steps for Children's Ground to capture the SIB opportunity.

The report is structured by first explaining the conceptual principles of SIBs in section 2. In section 3, what capabilities are needed to successfully implement a SIB funding arrangement are described. Section 4, explains the risks of not paying sufficient attention to the details of SIB design. Sections 5 and 6 describes specific SIB programs internationally and in Australia respectively. Section 7 outlines the complementarities of planning a Social Return on Investment (SROI) study as a possible precursor to designing a SIB. Finally, in section 8, this report will conclude will outline key next steps that Children's Ground can take to prepare for a SIB opportunity.

2 WHAT ARE 'SOCIAL IMPACT BONDS'?

SIBs are a form of 'pay for success' or 'pay by results' (PBR) funding mechanism (Disley *et al.* 2011; Social Finance 2011; McKinsey & Company 2012; Third Sector Capital Partners 2013). Similarly to other PBR mechanisms, the design of SIBs incorporates incentives to maximise the social benefits from the sought-after outcomes. However, there are significant differences between SIBs and other funding mechanisms. These differences provide important benefits but also introduce additional complexity for the design of SIBs. In this section, we will highlight the salient features.

2.1 PLAYERS

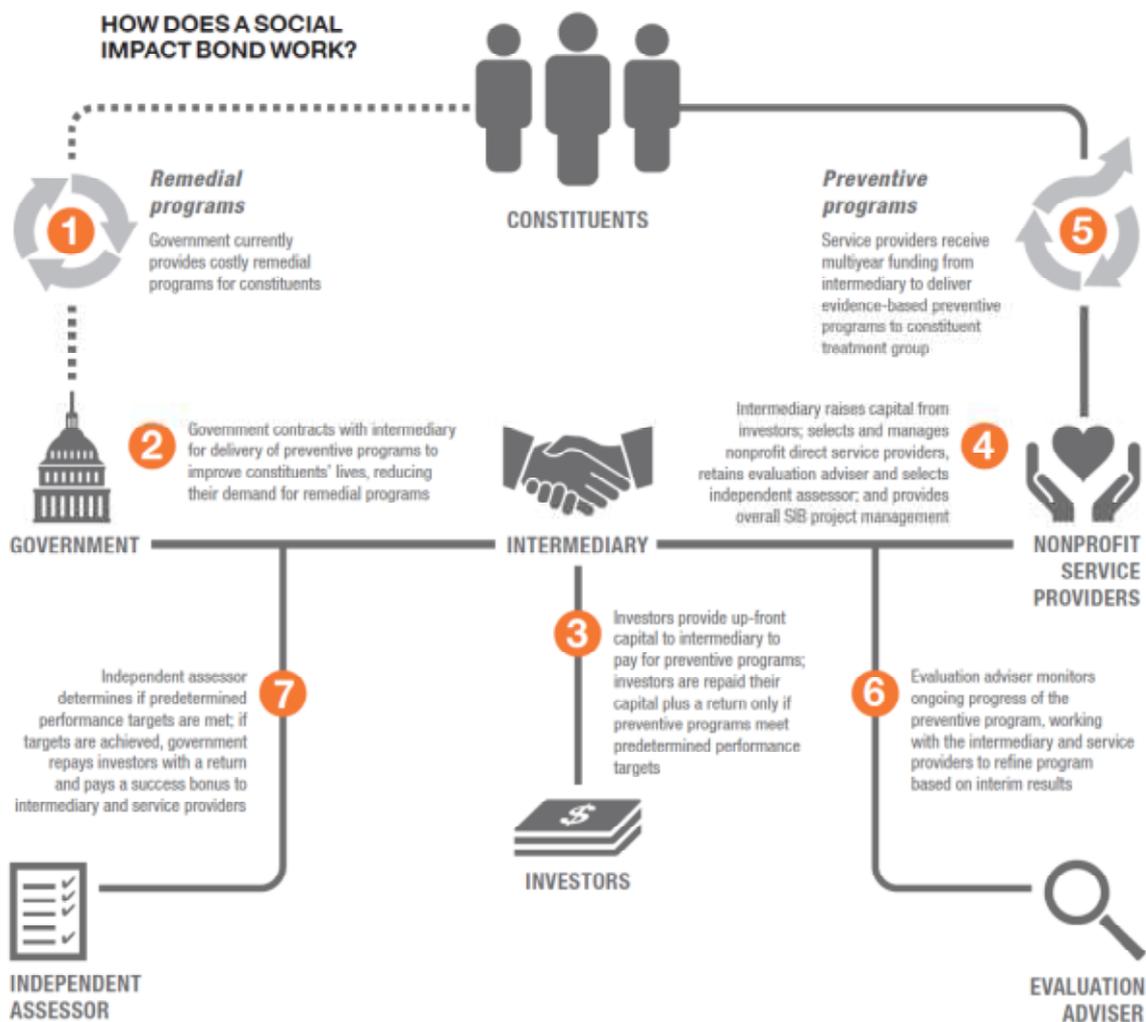
Figure 2-1 outlines how the basic SIB design works. There are several parties to a SIB transaction. There are three key parties that have a direct influence on the success of a SIB transaction. First, there is government that is looking to engage external social service deliverers. Governments' motives may vary from improving program effectiveness to budget constraints. Government is a key player in a SIB transaction from providing the authorising environment to allow such a transaction to be possible but also hold the key data that are used to determine 'success' and the funds to provide incentives for investors to provide the up-front capital (Disley *et al.* 2011; McKinsey & Company 2012; Third Sector Capital Partners 2013).

The second key party is the 'intermediary' (to adopt McKinsey's terminology). The intermediary is essentially a 'project manager' that manages all the relationships and the day-to-day operation of the service delivery. However, the intermediary is *not* the service provider. The intermediary manages the performance of the service provider and has the ability hire and fire service providers. The intermediary has both a fixed and performance-based compensation scheme (McKinsey & Company 2012): the fixed component compensates the intermediary for the ongoing project management services while the performance-based component aligns the intermediary's objectives with delivering on the social outcomes specified in the SIB outcome metrics. The intermediary is key differentiating feature between SIBs and other PBRs. In SIBs, the government has a 'hands-off' relationship with service delivery. SIBs are also characterised by the lack of prescription over how the sought-for social outcome is delivered (Disley *et al.* 2011; Liebman 2011; McKinsey & Company 2012). This allows the intermediary to select the most appropriate service provider to deliver the social outcomes.

The third key party are the investors in the SIB. These investors provide the up-front capital that enable the intermediary to contract service providers to work towards delivering the sought-after social outcomes (Disley *et al.* 2011; Liebman 2011; Social Finance 2011; McKinsey & Company 2012; Third Sector Capital Partners 2013). This is another key difference with other PBRs funding mechanism. Other PBRs mechanism require the service provision to raise the working capital to commence service delivery (Third Sector Capital Partners 2013). Investors are encouraged to participate in SIBs with the potential to earn above-market returns. Above-market returns are paid to investors if the intermediary is successful in delivering the social outcomes as specified by the outcome metric. However, as McKinsey and Company (2012) point out many times, SIBs are not really 'bonds'. Conventional bonds are considered very safe investments because the borrower is required to pay out a fixed payment at regular intervals and eventually the repayment of the whole principal.

However, SIBs do not have to pay out a guaranteed fixed payments. This feature, and the lack of track record, makes SIBs riskier investments to profit-seeking investors and may limit the attractiveness of SIBs as an asset class (Disley *et al.* 2011).

Figure 2-1



Glossary of terms

Remedial services: Government programs that address negative social outcomes after they've occurred (e.g., incarceration for criminals, emergency room access for the chronically homeless).

Preventive interventions: Social service programs that focus on avoiding negative social outcomes (e.g., alternatives to incarceration, permanent supportive housing for the chronically homeless).

Constituent treatment group: Those individuals who benefit from the preventive intervention and whose results are compared to others who did not receive similar services.

Source: McKinsey and Company (2012).

The other players in a SIB transaction as illustrated by Figure 2-1 are the independent assessor, evaluation adviser, the nonprofit service providers and constituents. These players have less direct influence on the structuring of the SIB but have a critical impact on the success of the SIB as a tool for

improving social outcome. The service provider is the agent that actually delivers the program on a day-to-day basis. The SIB is structured to ensure that the service provider can focus on service delivery. Service providers are paid on a fixed basis without a performance component. They have an incentive to deliver because the intermediary has the ability to fire them for lack of service-delivery (Disley *et al.* 2011; McKinsey & Company 2012). Service providers may also have a reputational incentive, especially for the early SIBs, to position themselves in order to obtain future SIB-related work (Disley *et al.* 2011).

Both the independent assessor and evaluation adviser are both evaluation specialists but have distinctive roles (McKinsey & Company 2012). The independent assessor has a key role in determining if the service provider achieved the sought-after outcome and if the investors and intermediary are entitled to performance payments. The independent assessor reports to government rather than the intermediary in order to maintain objectivity. They do not have a role in the performance or design of the SIB.

On the other hand, the evaluation adviser's role is to monitor the progress of the project and to provide advice on how to improve service delivery in order to achieve the desired social outcome (McKinsey & Company 2012). The role of the evaluation adviser is crucial given the evidence-based nature of the outcome metric (Disley *et al.* 2011; Liebman 2011; McKinsey & Company 2012; Third Sector Capital Partners 2013). The ongoing flow of evaluation information allows the intermediary to adjust the project in order to maximise success of achieving improved social outcomes. The collection of evaluation information allow governments to objectively assess if social programs are effective, unlike the case with conventional government programs (Liebman 2011).

Finally, constituents are the direct beneficiaries of the delivery of social programs financed by a SIB. Most social programs would require the active participation of the target population in order to achieve the desired social outcome. The target population would directly experience the benefits of the service delivery, but other constituents could also benefit from (depending on the program) lower crime and more efficient use of public funds (Disley *et al.* 2011; McKinsey & Company 2012).

2.2 FUNDING FLOWS

As mentioned in 2.1, governments do not provide up-front capital for SIBs, instead this is provided by private investors. Both investors and the intermediary are paid performance payments should the program deliver the desired social outcomes by the government. Theoretically, the government should be able to afford the performance payments if the improved social outcomes are delivered because this is correlated with lower government spending on remedial programs (Disley *et al.* 2011; Social Finance 2011; McKinsey & Company 2012).

2.3 INCENTIVE ALIGNMENT

SIBs are designed to align the incentives of the key players (government, intermediary and investors) with achieving the desired social outcome. The desired social outcome is expressed as a metric that is agreed between government and the intermediary when structuring the SIB (Disley *et al.* 2011). The design of an outcome metric should be able to capture the impact of the service provider in improving social outcomes otherwise the government may be paying for an outcome that would have eventuated anyway (Third Sector Capital Partners 2013). This can be done by incorporating a

'counterfactual' - the outcome that would have occurred and paying setting the metric such that it represents an improvement on the counterfactual. Other options are using randomized control trials or use of a similar site (Third Sector Capital Partners 2013). Designing an appropriate outcome metric would result in aligning the incentives of the intermediary and investors to achieve genuine improved social outcomes. However, the design of a robust outcome metric is a time consuming and data-intensive task that requires statistical analysis skills (Disley *et al.* 2011).

As pointed out before, performance payments are paid to investors and the intermediary but not the other players. Performance payments are used to encourage investors to provide up-front capital with the potential of receiving above-market returns. With the intermediary, the performance payment is more directly linked to service delivery because they are responsible for the delivery of the social program.

2.4 RISK TRANSFER

SIBs provides a means to transfer the risk of delivering a program to private investors (Liebman 2011; McKinsey & Company 2012). The private investors are exposed to delivery risk because they have provided the upfront capital. Government only pays if the program is successful in delivering the desired outcomes. Depending on the design of the performance payments, government may retain a portion of the budget savings so may also benefit from successful program delivery.

2.5 INNOVATION

Using SIBs may allow governments to 'scale up' innovative and promising social programs (Liebman 2011; McKinsey & Company 2012). However, there is some disagreement on to the extent that there will be genuine innovation. McKinsey and Company (2012) argue SIBs are best used for 'proven' policy programs. Liebman (2011) argues that it could be used for new approaches with evidence of effectiveness. Nevertheless, both agree that SIBs are a way of resourcing policy programs that are currently not being used.

2.6 PREVENTATIVE PROGRAMS

SIBs could enable governments to shift away from remedial (after the fact) activities to preventative activities (Disley *et al.* 2011; Liebman 2011; Social Finance 2011; McKinsey & Company 2012; Third Sector Capital Partners 2013). Given that prevention is often argued to be cheaper than remediation, this would have the benefit of avoiding all the associated costs as the result of preventable social problems such as crime.

2.7 LONG-TERM IMPACTS

In theory, SIBs can be structured to be as long as 10 years (Liebman 2011). This would have the benefit of providing financing to tackle difficult social problems over a suitable time frame. However, investors are unlikely to tolerate such long time frames before they are repaid their principal (Disley *et al.* 2011; McKinsey & Company 2012). McKinsey and Company (2012) suggest five years may be a more appropriate time frame for a SIB. Disley *et al.* (2011) propose having funding rounds during the life of a program to provide opportunities for investors to exit and new investors to buy into a SIB. Disley *et al.* (2011) also suggest that as SIBs mature as an asset class, that a secondary market could develop that would allow investors to trade SIBs similarly to what happens on the share market. A

secondary market could result in the issuance of long-term SIBs that could match the time required to tackle social problems.

2.8 IMPROVED ACCOUNTABILITY

The use of ongoing evaluation, outcome metrics and an independent assessor would improve transparency (Disley *et al.* 2011; Liebman 2011; McKinsey & Company 2012). This may encourage governments to look to replace existing programs that cannot demonstrate improving social outcomes, or at the least encourage agencies to collect data to determine program effectiveness (Liebman 2011). SIBs could be a useful tool to drive the cultural change of 'evidence-based decision-making' in government. As noted in Disley *et al.* (2011), SIBs represents a fundamental change in how governments currently deliver social programs by driving a focus on data and effectiveness rather than inputs.

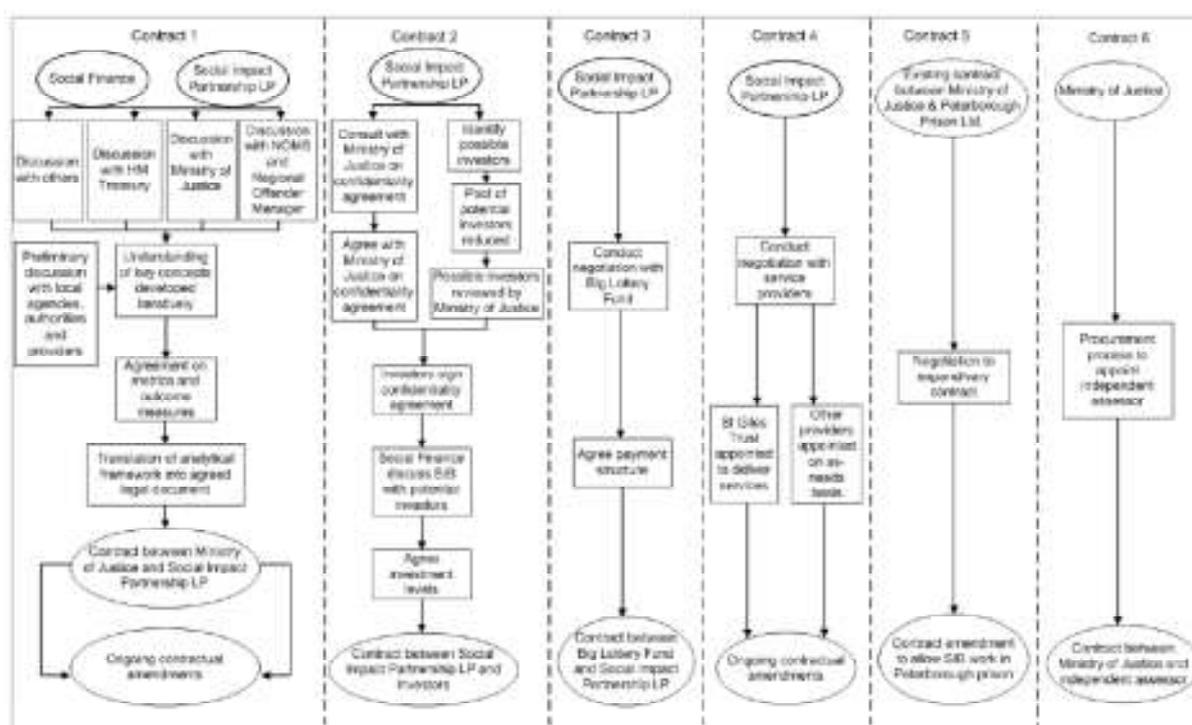
3 CAPABILITIES REQUIRED

The development of SIBs requires a multidisciplinary approach to successfully structure (Disley *et al.* 2011). Expertise from law, government, statistics, social service, finance, project management, evaluation and 'soft skills' are required to successfully develop a SIB. This section will explain how each discipline is necessary to successfully structuring a SIB.

3.1 LAW

Legal skills such as contract negotiations and drafting are required to rigorously develop a SIB that appropriately allocates each players' rights and responsibilities as explained in section 2. Furthermore, a SIB may require more than one contract as shown in Figure 3-1, in the case of the Peterborough SIB (Disley *et al.* 2011).

Figure 3-1



Source: Disley *et al.* (2011).

The complexity of the contracting process will depend on how 'bespoke' the SIB is. Given this early stage of development of SIBs, contract complexity and associated cost is likely to be high. Furthermore, specific contract specialists may need to be used especially those related to the investors' contracts.

3.2 GOVERNMENT

In the SIB literature, several researchers have pointed out that the sponsoring agency may not directly benefit from the successful implementation of a SIB-financed project (Disley *et al.* 2011; Liebman 2011; McKinsey & Company 2012). The sponsoring agency may support the SIB on policy rather than budgetary grounds. However, without the involvement of the agency benefiting from the cost

savings, the amount of funds available for performance payments may be smaller than expected. Furthermore, some agencies may actually lose from the successful implementation of a SIB program. For example, in the case of the Peterborough SIB in the UK, the private operator of HMP Peterborough may lose if the SIB-financed recidivism-reduction project was successful (Disley *et al.* 2011). Winners and losers in the government bureaucracy, other tiers of government and private contractors (among others) may be important enablers or barriers to the development of a SIB-financed program and its successful implementation.

Knowledge of government budgetary processes is important in successfully developing a SIB (Disley *et al.* 2011; Liebman 2011; Social Finance 2011; McKinsey & Company 2012; Third Sector Capital Partners 2013). Governments usually do not enter into long-term contracts unless it is for major infrastructure projects. The sponsoring agency may need to invest time and effort to negotiate with Treasury to enable a SIB contract. While the SIB contract does not require upfront payment by government, if a SIB contract is successful it could trigger *contingent liabilities* (Disley *et al.* 2011). That is, the government is liable if a specific contingency occurs. How contingent liabilities are treated within a specific government's accounting framework is an important consideration in determining if a SIB is possible.

Given the political nature of governments, having a clear understanding of the 'authorising environment' is important in determining how committed government agencies are to implementing a SIB (Third Sector Capital Partners 2013). Developing a SIB requires a significant amount of time and scarce resources so understanding if a SIB has high-level political support is important before initiating development. For example, in the Massachusetts recidivism-reduction SIB, the intermediary and service provider (Third Sector Capital Partners and Roca, respectively) met with senior government officials to determine government commitment before initiating the development of the SIB. They discovered that the Massachusetts Governor was strongly supportive of recidivism-reduction and was also supportive of PBRs and SIBs (Third Sector Capital Partners 2013). Change of government may affect the development of SIBs. However, for ongoing SIBs, strong contracts can prevent new governments from renegeing on performance payments.

3.3 STATISTICS AND DATABASE MANAGEMENT

As discussed in section 2, the construction of the outcome metric is crucial to determining whether or not a SIB-financed program was genuinely successful in improving social outcomes. Statistical analysis, collection and database management skills are crucial to the development of the outcome metric. Furthermore, given the importance of the outcome metric for determining performance payments, statistical skills needs to be an ongoing part of a SIB program to maintain the accuracy and validity of the outcome metric to the satisfaction of the government, investors and the intermediary (Disley *et al.* 2011).

Statistical skills are only useful if there is data available. Before proceeding with a SIB, the intermediary should determine if there is sufficient data available to construct a meaningful metric. Administrative data held by government would be ideal because the data has already been collected (Disley *et al.* 2011; Third Sector Capital Partners 2013). If data is not available, commissioning data collection may be necessary if resources allow for it. Otherwise, a SIB may not be feasible without sufficient data.

An outcome metric should be 'fit for purpose' rather than a perfectly accurate measure (Third Sector Capital Partners 2013). Developers of SIBs need to balance the costs of data collection, analysis and management with the accuracy of the outcome metric. The outcome metric needs to be robust enough that it is not vulnerable to 'cream skimming' behaviour by service providers (Liebman 2011). For example, the metric should be constructed in such a way that service providers focus on cases that will benefit the most from the program rather than the easy cases. For example, in the case of recidivism, the outcome metric could specify on improving the outcomes for groups that have been shown to most likely reoffend (Third Sector Capital Partners 2013).

3.4 SOCIAL SERVICE

In depth knowledge of social policy activities, or at least the capability to learn quickly, is required to understand what is feasible for a SIB program to achieve (Disley *et al.* 2011; Social Finance 2011; McKinsey & Company 2012). This knowledge is crucial for developing the SIB contracts and the outcome metric because they will define what the intermediary is accountable for and the conditions when performance payments are made.

The implementation of the SIB requires the use of effective service providers. The intermediary is responsible for selecting the most qualified service provider to deliver the desired social outcome. Therefore, the SIB needs to have a strong understanding in how a service provider's model and activities can lead to sought-for outcomes.

3.5 FINANCE

The whole objective of SIBs is to link private investors with social policy activities (Liebman 2011; Social Finance 2011; McKinsey & Company 2012). Knowledge on how to structure a SIB to appeal to investors is important to attract private capital to improve social outcomes. This requires skills in structuring a transaction to allocate risks and returns that would best appeal to investors. This is especially important given the wide range of investment products available to institutional investors (e.g. superannuation funds).

A key impediment to marketing SIBs is the lack of a performance track record (Disley *et al.* 2011; McKinsey & Company 2012). This would probably discourage most institutional investors investing in SIB until a sufficiently long dataset is generated to provide investors with enough information to analyse the performance of this asset. This information is important to allow institutional investors how SIBs would affect the risk-return profile of their clients' portfolios. Until then, most investors would probably be philanthropic and 'impact investors' rather than conventional return-seeking institutional investors.

3.6 PROJECT MANAGEMENT

The intermediary needs to be able to manage multiple relationships and the delivery of one or more project to improve social outcomes (Disley *et al.* 2011; Social Finance 2011; McKinsey & Company 2012). This requires well-developed project management skills to effectively manage multiple relationships with varying needs and to be able to manage and report on multiple work flows. The intermediary needs to be more than someone who prepares reports, but also who is pro-actively managing relationships and workflows to achieve improved social outcomes. The intermediary also needs to be capable to select the most appropriate service provider for the needs of the SIB. Finally,

the project manager needs to be able to manage multidisciplinary and diverse teams to achieve improved social outcomes.

3.7 EVALUATION

As mentioned in 2.1, evaluation has two distinct roles: performance assessment and performance enhancement. In both cases, experience in evaluating social policy programs is necessary. However, given the ongoing advisory nature of the evaluation adviser's role, a deep knowledge of how a given social policy program drives results is necessary in order to be effective in discharging the 'performance enhancement' duty. In contrast, the independent assessor's role is to compare current performance to the outcome metric. However, to be truly objective, the independent assessor would have to be able to construct their own database rather than rely on the evaluation adviser's data.

3.8 'SOFT SKILLS'

'Soft skills' such as relationship-building and stakeholder-management are critical skills for the intermediary and service providers to effectively implement the SIB program. For the intermediary, these skills are necessary to successfully develop a SIB that meets the needs of government, investors and delivers improved social outcomes for the target population. Furthermore, these soft skills are useful during the operation of the SIB in managing investors' and government's expectations. For the service providers, soft skills are necessary to be effective with the target population to gain their trust and to work with them to achieve improved social outcomes for them.

4 RISKS OF POOR DESIGN

There are several risks if insufficient attention is paid to the design of the SIB program. We broadly outline the consequences of three key risks and suggestions on how to manage them: perverse incentives, insufficient performance payments, and mismatched time frames.

4.1 PERVERSE INCENTIVES

A well-designed SIB should align the incentives of the intermediary with improving social outcomes. However, there are several ways to undermine incentives if the outcome metric is poorly defined. First, the outcome metric may not be correlated with the actual desired social outcome (Liebman 2011). This could be the result of lack of data that may result in a weak correlation to the desired outcome. The result could be a case where service providers are instructed to concentrate on activities rather than on producing the desired outcomes. For example, a poorly defined outcome metric may actually be an output metric that quantifies activities (e.g. meetings, students that attend class, etc) rather than outcomes (e.g. students that improve their numeracy). This risk can be managed by first determining what outcomes are sought as precisely as possible (preferably, with a quantitative element) and secondly, determining if the data exists to enable the construction of an outcome metric that is correlated with the outcome.

Another way metrics can pervert incentives is if the target group is poorly defined in the counterfactual so that the metric may provide a distorted view of the outcome (Liebman 2011). For example, for a recidivism-reduction project, the target group may be broadly defined to include all young adults that have been incarcerated as children regardless of risk factors. This could result in service providers being instructed to 'cream skim' by focusing on young adults who have low risk factors rather than the riskier and most in need cases (Third Sector Capital Partners 2013). This risk can be managed by identifying those cases that are most at risk and would benefit the most. This would require some detailed statistical analysis (Disley *et al.* 2011; Third Sector Capital Partners 2013).

4.2 COMPLEXITIES OF GOVERNMENT RELATIONSHIPS

As mentioned in 3.2, the sponsoring agency may not be the agency that receives the budgetary savings. This could result in an insufficient performance payment to entice potential investors and intermediaries to participate in the SIB. At worse, it could prevent the SIB from proceeding. This risk can be managed by including the agency that would benefit financially from the SIB. One way this can be achieved is by engaging Treasury in participating in the SIB. Treasury is interested in seeking opportunities for cost savings and would have the bureaucratic influence to compel agencies to participate.

The Australian Federal system adds a further dimension of complexity because of overlapping responsibilities in social policy. A thorough understanding of which agencies at Federal, State and maybe local level would be necessary to include all the relevant agencies that have an interest in the savings from the SIB program. Managing multiple layers of governments with potentially conflicting interests is a key challenge for the intermediary and would require strong knowledge of government and relationship-management skills.

4.3 MISMATCHED TIMEFRAMES

A serious design issue is the mismatched time frames between the time required to improve social outcomes and investors' preferences (Disley *et al.* 2011; Liebman 2011; McKinsey & Company 2012). A SIB program that ends before outcomes can be fully achieved could result in reversals of the gains or even harm to the target populations (Disley *et al.* 2011; McKinsey & Company 2012; Third Sector Capital Partners 2013). This risk could be mitigated by accepting investors who have similar objectives as the SIB such as impact investors and philanthropists. However, as SIB matures as an asset class and interest by profit-seeking investors grow, other options may arise such as secondary markets that would allow investors to trade SIBs to suit their preferences.

5 INTERNATIONAL EXPERIENCES AND LESSONS

To date, there are currently no completed SIBs that we can draw lessons on. However, SIBs have generated great interest from government, service providers and investors in their potential to overcome funding constraints imposed by current arrangements (Disley *et al.* 2011; Liebman 2011; McKinsey & Company 2012). Below are three examples that will be discussed, including the first example of a SIB.

5.1 HMP PETERBOROUGH, UK

The HMP (Her Majesty's Prison) Peterborough SIB is the world's first SIB (Disley *et al.* 2011). The program was focused on reducing recidivism of prisoners discharged from short-term sentences (12 months or less) from HMP Peterborough in three cohorts. Performance payments are paid when a cohort experiences a 10% reduction in recidivism. The reduction is measured 1.5 years after the cohort's release. If this does not occur, a performance payment is paid at the end of the third cohort if on average the cohorts achieved a 7.5% reduction in recidivism.

5.1.1 PLAYERS

The Ministry of Justice (MoJ) entered into a SIB contract with the intermediary, Social Finance, in September 2010 (Disley *et al.* 2011). MoJ appointed QinetiQ as an independent assessor in a separate contract. Social Finance, through a limited partnership structure, Social Impact Partnership LP, engaged service providers St Giles Trust and others. Social Impact Partnership LP also entered into separate contracts with investors. A contract was entered into with the Big Lottery Fund who would part fund the performance payments with the MoJ. Notably, the MoJ was involved in reviewing specific investors as part of the contracting process.

Other notable players were HM (Her Majesty's) Treasury, the National Offender Management Service (NOMS) and staff from the private prison HMP Peterborough. These players were not formally contracted but had key enabling roles in the HMP Peterborough SIB. HM Treasury was involved in the contracting process with MoJ because of the novel nature of the procurement. For example, unlike other government procurement, this SIB was not competitively tendered out. Involving HM Treasury would be necessary to creatively overcome procedural barriers that would normally prevent a SIB from being developed.

NOMS and the private operator of HMP Peterborough are both accountable to MoJ. However, this is no guarantee that they would cooperate. Engaging them in the contracting process would allay concerns that the SIB may threaten their resources (Disley *et al.* 2011). Engagement also enabled Social Finance and MoJ could tap their expertise to develop the SIB contracts. The cooperation of HMP Peterborough was particularly important because it would be the site of the SIB-financed program. Being a private contractor, HMP Peterborough could have refused to cooperate because it was outside the scope of their contract to allow external service providers onto their site. However, management at HMP Peterborough saw it as part of their role to reduce crime in the broader community (Disley *et al.* 2011). They saw the Peterborough SIB as an opportunity to reduce broader crime in the community and were willing to support the SIB program after contractual modifications.

There was no formal evaluation adviser in the Peterborough SIB. Instead, Social Finance was advised by an advisory group with law enforcement, legal and financial expertise, and a Data Management

Group (Disley *et al.* 2011). The advisory group provided advice on service delivery. The Data Management Group was made up of staff from Social Finance, MoJ analytical and procurement staff, and the independent assessor. This group dealt with issues arising from data collection and management as it relates to the outcome metric. This group had agreed to contract definitions to maintain the consistency between the contract and available data.

As mentioned before, Social Finance used a limited partnership structure, Social Impact Partnership LP, as the contracting entity. This is normal financing practice to limit liability to the financial intermediary (i.e. Social Finance) in the event its contracting partners were unable or unwilling to fulfil their financial obligations.

5.1.2 PROOF OF CONCEPT

There was general acknowledgement amongst the players that the Peterborough SIB was a world's first and that it was essentially a proof of concept and a learning opportunity that could potentially lead to a change in social policy and the introduction of a new asset class (Disley *et al.* 2011). Given this spirit of learning on all sides, there may have been some lenience in how the SIB was treated from a government procedural and investors' perspective.

The Peterborough highlighted that regular government accounting and procurement processes require modification to accommodate more frequent use of SIBs by governments. There was general acknowledgement that SIBs were a completely new way for government to finance and implement social policy programs (Disley *et al.* 2011). The main difference was the change in relationship between government and service providers. Government no longer has a direct relationship with the service provider through an 'output-based' contract. Instead, it is contracting purely for outcomes without prescribing how the outcome is delivered. It is unclear how sustainable this arrangement is, especially if the program is high profile.

Other procedural irregularities would probably be accommodated as SIBs mature. Some may not require procedural modification. For example, the Peterborough SIB was not competitively-tendered out (Disley *et al.* 2011). This was mainly because the SIB idea was initiated by Social Finance and there were no other possible intermediaries at the time. However, this is likely to change if more SIBs are implemented. Procedural changes would be required to reduce the administration costs of SIBs to government agency. For example, MoJ had to obtain special approval from HM Treasury to account for performance payments as 'contingent liabilities' in their budget (Disley *et al.* 2011). This would appear to be a routine accounting procedure for SIBs that would not require HM Treasury's oversight.

A more fundamental change for government is the use of data and analysis to rigorously design the SIB outcome metric and for evaluation and assessing program success. Intensive use of MoJ's data and analytical resources were used to design the outcome metric (Disley *et al.* 2011). The design of a successful SIB is predicated on being able to construct a robust quantitative measure that can capture progress towards improving social outcomes. The greater use of SIBs would increase the importance of data collection, analysis and management as existing and new social policy programs seek to compete for scarce resources.

In terms of assessing if the Peterborough SIB was successful in its goal of attracting private capital to finance social policy activities, it is clear it was successful in raising funds but it is unclear if it indicates

there is significant latent investor appetite for SIBs. Investment in the Peterborough SIB were made by philanthropic and impact investors rather than profit-seeking institutional investors (Disley *et al.* 2011). Philanthropic and impact investors were interested to learn from the Peterborough SIB as a potential tool for social improvement. Profit-seeking investors were unlikely to invest in SIBs until a sufficient track record had been accumulated that would allow them to evaluate how it would affect the risk-return profile of their investment portfolios.

5.1.3 LESSONS

The Peterborough SIB highlighted that government procurement and accounting processes are not ready for SIBs. Unless there is a committed champion within government that is willing to take risks, invest in building support and think creatively to push SIBs, it is unlikely SIBs will become a reality. Identifying a champion, at a senior level, or a policy driver for SIBs is crucial to ensure the development of SIBs.

Unlike the McKinsey and Company's (2012) depiction of SIBs (see Figure 2-1), the Peterborough SIB shows that it is not necessary to have a contracted evaluation adviser. Instead, Social Finance were advised by the advisory group and the Data Management Group on an ongoing basis. When developing a SIB, an intermediary could keep an open mind about who could fill the role of an evaluation adviser.

Another key lesson of the Peterborough SIB is the importance of data analysis for the development of a SIB. However, there has been a general trend in government agencies to cut back on 'luxuries' such as analytical expertise and contract consultants. Furthermore, many agencies have also reduced spending on data collection. Analytical expertise could be contract in by an intermediary, but in the case of Peterborough, MoJ contributed analytical support gratis. Contracting in analytical services is likely to be costly. Furthermore, the data may not be available to calculate the outcome metric and the available pool of performance payments. A potential intermediary should check if the agency holds data that would be useful for the calculation of outcome metrics and performance payments. If not, external agencies may hold it. Otherwise, it is unlikely a SIB will be feasible.

5.2 MASSACHUSETTS RECIDIVISM REDUCTION, USA

The Massachusetts SIB has yet to be implemented but Third Sector Capital Partners has been selected as the intermediary (Third Sector Capital Partners 2013). However, there are some lessons that can be learned for competitively-tendering and structuring SIBs.

5.2.1 COMPETITIVE TENDER OF SIBS

When the Commonwealth of Massachusetts called for proposals to reduce recidivism, the request asked for PBR proposals rather than specified it was a call for SIBs (Third Sector Capital Partners 2013). However, they would welcome a SIB proposal if one was put forward. The request did not specify outcome metric or payment structure, this was left to the proponents' to specify.

Third Sector Capital Partners was contacted by a service provider, Roca, for assistance in putting a proposal together (Third Sector Capital Partners 2013). Given the complex legal, financial, statistical and social policy issues that a proposal would have to tackle, significant expertise, resources and time were required. The request for proposals was issued in May 2011. Selection of Third Sector Capital

Partners and Roca did not occur until August 2012. Therefore, there was over one year spent preparing a proposal and waiting for the outcome.

A key lesson for competitive tenders for SIBs is the resource-intensive nature of responding to a request. Preparing for such an opportunity would involve building relationships with possible partners and experts in legal, finance, statistics and social policy that could assist with a proposal. Also, having sufficient working capital to fund a lengthy preparation would be beneficial.

5.2.2 STRUCTURING SIBS

Third Sector Capital Partners proposed to structure the SIB in three tranches:

- First tranche. Provide capital upfront and receive 2-4% risk premium on performance payment. Will be the first tranche to be reimbursed.
- Second tranche. Provide upfront capital but no risk premium on performance payment. Will receive principal repayment after first tranche. In addition, will be 'second loss' tranche.
- Third tranche. Provide non-recoverable capital to provide 'first-loss' protection to the other tranches.

The structure of the SIB is analogous to the capital structure of a company in terms of risk to the investor. The first tranche is similar to 'senior debt' in that it is the safest layer of the capital structure. The second tranche is analogous to 'junior debt' because it is the second-loss tranche in the structure. Finally, the third tranche can be likened to 'equity' because it is the riskiest part of the capital structure as the first-loss tranche.

The structure of the Massachusetts SIB is similar to a 'Collateralised Debt Obligation' (CDO) that were commonly used to package mortgages and then on-sold to investors. The advantage of a CDO structure for SIBs is that it provides a way of accessing profit-seeking as well as philanthropic funds. The first tranche would appeal to profit-seeking investors because it is the least riskiest and they receive a risk premium. Philanthropic investors seeking modest returns would prefer the second tranche. Philanthropists that are not concerned with earning a return would be comfortable being in the third tranche. Note, the third tranche is insurance for the first and second tranches rather than used as working capital. This additional layer of protection (or 'credit enhancement' in financial jargon) further reduces the risk for first and second tranche investors. No specific monetary values were given to determine how much protection was afforded by the third tranche to other tranches.

This structure has the potential to access broader investment pool than the Peterborough SIB because of the layers of protection given to profit-seeking investors. While it appears the third tranche is not being used for working capital, it has an important enabling function in reducing the risk for other investors and would allow this SIB to access a broader investment pool than would otherwise be possible.

5.3 RIKERS ISLAND, NEW YORK USA

The Rikers Island SIB is similar to the HMP Peterborough SIB in that it finances recidivism reduction in a prison (i.e. Rikers Island) (The City of New York Office of the Mayor 2012). It was the first SIB in the US and was structured by the investment bank, Goldman Sachs (Olson and Phillips 2013). The key lessons from this SIB is in how it has been structured.

The Rikers Island SIB has a similar structure to the Massachusetts SIB. Instead of three tranches, there are two:

- Senior loan tranche. \$US9.6 million loan provided to the intermediary (MDRC) as working capital by Goldman Sachs. Downside risk limited to \$US7.2 million. Upside risk depends on how successful MDRC was in reducing recidivism above 10% (\$US9.6 million) to 20% or more (\$US11.7 million) (Olson and Phillips 2013).
- Guarantee fund tranche. \$7.2 million to credit-enhance the senior loan tranche provided by Bloomberg Philanthropies. Fund provide progressively over time so Goldman Sachs will bear some exposure to MDRC's performance. If there is any remaining guarantee fund at the end of the SIB, MDRC will be able to retain for future projects (Olson and Phillips 2013).

The loan repayment and the performance payment is financed by the City of New York.

The Rikers Island structure is interesting because of the design of the guarantees as a risk-mitigant and potential performance payment for the intermediary. As a risk-mitigant, the guarantee enables Goldman Sachs to provide financing to a project with essentially unknown risk. As an incentive, MDRC has a strong financial incentive to succeed because it could receive \$7.2 million at the end of the SIB.

In addition, the Rikers Island SIB is also notable for the involvement of Goldman Sachs in structuring and financing the SIB. Given its rapacious reputation, it is surprising to see Goldman Sachs retain some exposure to MDRC's performance risk. Although, this is largely mitigated by the guarantee provided by Bloomberg Philanthropies.

6 AUSTRALIAN EXPERIENCE, NSW SOCIAL BENEFIT BONDS TRIALS

The New South Wales (NSW) Government selected three proponents to pilot three separate 'Social Benefit Bonds' pilots in March 2012 (New South Wales Government undated). Mission Australia and partners are piloting a recidivism reduction pilots. The Benevolent Society, Westpac and Commonwealth Bank of Australia, and UnitingCare Burnside are piloting two separate out of home care trials. Similar to the Massachusetts trial, the New South Wales trials were competitively tendered out. Unfortunately, there is insufficient information to determine if the NSW competitive tendering out process was as onerous as the Massachusetts SIB trial.

In this section, we discuss the Newpin Social Benefit Bond trial because it has been the most discussed of the SIBs.

6.1 NEWPIN SOCIAL BENEFIT BOND

The Newpin Social Benefit Bond is a \$7 million program with a seven years term (Social Ventures Australia undated). The outcome metric is the restoration of children to their families' care (New South Wales Treasury undated). This outcome, unlike the Peterborough SIB is determined independently by the NSW Children's Court. Therefore, it avoids many of the analytical demands that the recidivism reduction SIBs required.

Similar to the Riker's Island trial, performance payments are determined on a progressive scale as shown in Figure 6-1.

Figure 6-1

Restoration Rate ⁱⁱⁱ	Interest Rate ^{iv}	Principal Repayment on Maturity ^v
60%	7.5%	100%
65% (Target)	12.0%	100%
70%	15.0%	100%

Source: Social Ventures Australia (undated).

In addition, there are the following guarantees:

- Minimum 5% interest in first 3 years.
- Principal protection of 75% in first 3 years and 50% in remaining years.
- Early termination right for poor performance from year 3.

Given the relatively high return and the credit-enhancements, Newpin appeared to be an attractive value proposition to investors because it was fully subscribed (Social Ventures Australia undated). Furthermore, from Figure 6-1, we can see that Newpin target restoration rate is 65%, presumably per year. No information was given on how this was calculated or what the relevant counterfactual was. According to Social Ventures Australia (undated), Newpin has historically achieved a restoration rate

of 74.5%. If this performance continues, investors in Newpin SBB may receive 15% return per year. Given all these factors, it is clear that the expected return and the credit enhancements makes this a very attractive investment.

However, credit enhancements are only possible if another party is willing to bear the risk. There is no information on who the counterparty is for the credit enhancements which may introduce what is called 'counterparty risk'; i.e. the risk that the counterparty does not honour their commitments. Given it is a trial initiated by the NSW Government, we could assume that they will be the counterparty for the credit enhancements.

There is no doubt this is an attractive investment for profit-seeking investors. However, there are doubts that it will be financing genuine social improvements given the lack of detail on how the restoration target rate of 65% was selected and that it is significantly lower than Newpin's historical restoration rate of 74.5%.

7 RELATIONSHIP WITH SROI

The information required to develop a SIB is similar to what is needed to complete a Social Return on Investment (SROI) study. Both require rigorous estimation of the benefits and costs of a program. Both require thinking intensively about the relevant counterfactual and estimating the genuine improvement attributable to a social policy program. It is true SROIs are broader than SIBs by incorporating environmental benefits and costs (The SROI Network 2012). Nevertheless, there is significant overlap that can be exploited to reduce the costs of doing a SROI or SIB individually.

There are two types of SROI: evaluative and forecast (The SROI Network 2012). Both are relevant to SIBs. Evaluative SROI are retrospective and attempt to estimate social returns based on actual data. Forecast SROI are forward-looking and attempt to estimate the expected social returns from a program. Skills and resources (e.g. data) used to complete either type of SROI studies can be transferred to SIBs.

Conducting both types of SROI studies as a normal course of operation can help a service provider prepare for a SIB opportunity by first, demonstrating performance and, secondly, establishing the operational, analytical and data collection systems that would be required, or could be built on, to successfully implement a SIB. Establishing such an operational model and evidence would provide assurances to potential investors and partners that an organisation knows how to deliver social value and therefore would be an attractive investment in a SIB.

8 NEXT STEPS FOR CHILDREN'S GROUND

If Children's Ground are considering SIBs as a potential source of capital, it would need to be able to demonstrate to government, investor, intermediary and other partners that it has an operational model that is a viable proposition for SIB financing. Children's Ground would need to demonstrate the social and financial benefits of its approach. In addition, Children's Ground would also need to demonstrate it has the operational model to deliver and the monitoring and evaluation systems that can credibly track progress. For Children's Ground to demonstrate it has a viable proposition to exploit a SIB opportunity, I advise the organisation to take the following steps.

STEP 1: ESTABLISH BASELINE DATASET

For Children's Ground to successfully design and market a SIB, evidence is required to demonstrate the proposed program would have a genuine social improvement. This means the collection of an appropriate baseline dataset is crucial for convincing potential investors that the organisation has an operational model that delivers results. This task should be given priority given that Children's Ground has already commenced implementing its collaborative model. A useful first step is to determine what type of variables does Children's Ground want to influence. These variables should be explicitly linked to the objectives of the collaborative model. When the variables of interest have been determined, the next step could be to determine what type of data was collected before the implementation of the Children's Ground collaborative model. This data could be used to determine the baseline from which net social impact can be measured.

STEP 2A: IMPLEMENT MONITORING AND EVALUATION SYSTEM

The second part of determining if Children's Ground is producing a genuine social impact is to implement a monitoring and evaluation system that can collect and store impact data generated from the delivery of services. The monitoring and evaluation data should be based on the variables of interest that has been determined in Step 1 in order to determine if there has been a genuine social improvement. Given the greater availability of portable tablets or smart phones, these technologies can be used to collect the data as part of the ongoing operation of Children's Ground collaborative model. The incorporation of such technologies can also have a beneficial effect of developing a culture of monitoring and evaluation throughout the organisation. Furthermore, incorporating a user-friendly method of reporting progress would allow Children's Ground to keep key stakeholders informed of progress as well as demonstrate that it has the data management systems in place to rigorously demonstrate impact as a part of a SIB program.

STEP 2B: UNDERTAKE SROI

As discussed in chapter 7, developing a SROI has complementarities with a SIB. The SROI could have an explicit secondary goal of analysing the financial feasibility of a SIB. For example, the SROI could be used to identify the public agencies that would benefit from a potential SIB-funded program and calculate the potential budget savings. The SROI could then provide a preliminary analysis on the benefits and budget savings to government from a SIB-financed program.

Because of the dual goals of a SROI study for Children's Ground, the SROI would be ideally undertaken by service providers who have experience in both SROIs and SIBs. Social Ventures Australia is a good example that has experiences in both SROIs and SIBs. This step can be done concurrently with Step 2a assuming it is undertaken by an external service provider.

STEP 3: DEVELOP A SIB PROPOSAL

The results from steps 2a and 2b would provide sufficient information to determine if a SIB was feasible. The results from ongoing monitoring and evaluation would provide important information on the effectiveness of Children's Ground collaborative model. This information can be used in SIB development to determine the trigger for performance payments. The SROI will provide information to potential government and investment partners on what kind of social and financial returns would be possible. This information can be used to design and model cost and returns for investors.

These two pieces of information can be used as the core content of a 'road show' to potential intermediary, government and investment partners to demonstrate the social and financial returns from the proposed SIB. Using data that was produced by robust monitoring and evaluation systems and obtaining certification on the credibility of the data (e.g. expert review) would provide assurance to government and investors that Children's Ground has been delivering genuine social impact and would be a reasonable investment proposition. Furthermore, the SROI report from a certified SROI practitioner (e.g. Social Ventures Australia) would also provide evidence to government and investor stakeholders on the merits of the proposal.

If there is strong interest from government and investors generated from the SIB 'road show', Children's Ground could develop a more formal proposal. This could be done as a result of responding to a formal tender request by key government stakeholders (e.g. at Ministerial or department head level) championing the use of SIBs. The proposal should be undertaken by the intermediary since they would have to develop the necessary social, financial and relationship knowledge to successfully manage the SIB. Some of this knowledge could be developed through developing the SROI. However, more specific information, such as the details of the performance metric, will have to be developed as part of the SIB proposal.

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