



Frequently Asked Questions: Social Impact Bonds

Kristina Costa, Sonal Shah, Sam Ungar, and the Social Impact Bonds Working Group

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Introduction

Social impact bonds are new and innovative financing mechanisms for social programs in which government agencies pay only for real, measurable social outcomes—after those results have been achieved. These tools effectively invert traditional government financing for preventive social services: In a social impact bond agreement, the government pays for realized outcomes at the conclusion of a contract, rather than paying upfront for programs or activities that may or may not have their anticipated effects.¹

At the same time, the social impact bond mechanism gives private investors the opportunity to provide operating funds for initiatives that have the potential to prevent or mitigate serious social problems and reduce government costs for later remedial services. These private funders make the initial investments in programs, and they are ultimately repaid, with a modest return, if the initiative is successful and achieves its goals.

It seems straightforward enough until you start to think about how social impact bonds actually work. Who chooses the required outcomes, and how are they set? Who decides if the outcome has, in fact, been achieved? How does the government decide what it will pay for a successful outcome? Who puts the “bond” in social impact bond? How long do these deals last? How can governments address appropriations for social impact bond payouts that may or may not happen? Who are the investors? Where is this tool appropriate to use, and where will it simply not work well?

Social impact bonds are complex tools, and a social impact bond agreement involves the interests of multiple stakeholders, including agencies at different levels of government, the external organizations with whom the government will contract, the service providers whom the external organizations will oversee, the investors who will provide working capital to run the interventions, and, of course, the public at large. All of these groups have similar questions and concerns about social impact bonds, as well as questions unique to their perspectives.

This Frequently Asked Questions guide is intended to address common questions raised by all of these stakeholder groups in plain, straightforward language. It is not, however, a comprehensive guide to designing, negotiating, or implementing a social impact bond agreement. Instead, this document should serve as a tool to direct your thinking as you consider how these new financing tools can be used in your agency or issue area.

This guide is divided into three sections. The first, “Social impact bonds 101,” answers basic questions about the tool, how it works, and who the key players are in any agreement. The second section, “Questions from government,” addresses technical concerns about budgeting, appropriations, and other topics. The third section, “Social impact bonds 201,” addresses higher-level questions about setting outcomes, evaluation methodology, and concerns about the tool’s function in government.

Social impact bonds 101

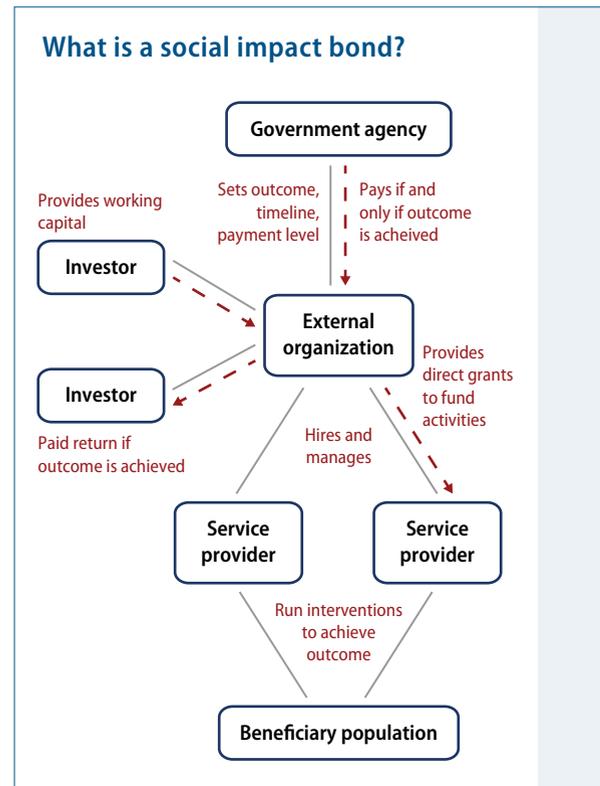
What is a social impact bond?

A social impact bond is an innovative financial arrangement between one or more government agencies and an external organization—sometimes called an “intermediary”—that can be either a nonprofit or a for-profit entity.² In a social impact bond agreement, the government sets a specific social outcome or set of outcomes it wants achieved relative to a defined population over a given time period, and promises to pay the external organization a pre-arranged sum if and only if the organization is able to accomplish the desired outcome. Social impact bonds are sometimes referred to under the umbrella of “pay-for-success” financing.

A social impact bond also requires a secondary layer of contracts between the external organization and other groups to which the government is not a party. First, because the external organization only receives payment from the government after achieving said outcome, the external organization will usually turn to outside investors to provide the working capital needed to fund the programs or interventions. Second, the external organization will often choose to hire service providers to conduct the actual interventions and, depending on the organization’s internal capabilities, may retain an evaluation adviser to help with data analysis and track progress toward the outcome.

When the intervention is complete and if a third-party assessor confirms success, the government releases funds to the external organization, which then repays the investors with a modest financial return.

Because the external organization is taking on considerable reputational and financial risk in signing on to a social impact bond, the government should give the external organization considerable latitude in choosing the interventions and service providers it will use to accomplish the outcome. Social impact bond contracts should contain language providing appropriate government oversight



for the purpose of protecting the populations being served, but the agreements should not mandate which interventions can be used—or how they can be used. Constricting the external organization too much could limit its ability to achieve the desired effects in the desired timeframe.

Social impact bonds hold a great deal of promise in funding primarily preventive social interventions that have the potential to save government money down the line. The amount the government is willing to pay for a successful outcome may be calculated in part based on these anticipated future savings, but it should not be calculated primarily based on the external organization's anticipated costs. While early discussion of social impact bonds has emphasized basing payments on the amount of money the government can reasonably expect to save from a successful outcome, it's important to remember that the measured impact of a social impact bond should consider the total benefits to society—not just the short-term savings.³

Who are the key players in a social impact bond agreement?

There are many moving parts to a social impact bond. As you learn more, you should keep these key players in mind:

- **Government.** A government agency or agencies will typically be the initiating party in a social impact bond contract; will have primary responsibility for defining the outcomes, population, and timeframe of the social impact bond; and will make the payment if the outcome is achieved. The government agency, however, should not take an active role in determining how the outcome is achieved.
- **External organization/intermediary.** As the counterparty to the main social impact bond contract with the government, the external organization can be a nonprofit or for-profit entity that may take on a number of roles, including hiring and overseeing service providers, raising working capital from investors, and managing overall progress toward the outcome.
- **Investors.** Investors provide working capital to pay for the interventions used to achieve the outcome. If the social impact bond is successful, the external organization then repays investors with a rate of return negotiated upfront between the two parties.

- **Service providers.** Service providers with proven track records of success will be hired and managed by the external organization. The service providers' pay is not entirely contingent on the outcome being achieved—they instead receive direct, sometimes multiyear grants from the external organization, which uses the capital fronted by the investors.
- **Independent assessor/evaluator.** A third-party evaluator verifies the achievement of the outcome using a methodology agreed upon by all parties—the government, the external organization, the investors, and the service providers—at the outset of a social impact bond agreement.

What are some key terms in a social impact bond?

Key terms that are commonly seen in a social impact bond agreement include:

- **Outcome:** A narrowly defined and empirically verifiable result of public policy.
- **Intervention:** A program, activity, or service used to achieve the outcome.
- **Population:** The group of people to which an improved outcome is being targeted and who will receive services under the terms of the social impact bond.

Is a social impact bond actually a bond?

Not technically. Bonds generally have an unconditional and guaranteed rate of return, while a social impact bond is entirely contingent on performance and rates of return may vary. Bonds are financial instruments that can be bought and sold, while social impact bonds are not. Social impact bonds are significantly riskier than many traditional bonds because the investors stand to lose up to 100 percent of their capital if the desired outcome is not ultimately achieved.

It's much easier to largely ignore the “bond” in social impact bond and think instead of a social impact bond as a contractual relationship between the government and an external organization.⁴ The relationship is formed when an external organization agrees to arrange and manage social interventions in pursuit of a defined outcome in exchange for a payout if successful. If the external organization achieves the desired outcome on schedule, the government pays out an agreed-upon return. If outcomes aren't achieved, then the external organization receives no payment from the government.

What kinds of challenges do social impact bonds address for governments, service providers, investors, and philanthropic entities?

Social impact bonds provide a mechanism to address a wide range of longstanding challenges around social service provision.

There are essentially two kinds of social services that the government or nonprofits can provide: remedial interventions, which seek to resolve social problems after they occur, and preventive interventions, which seek to address social challenges before they grow too acute. Prison time, for example, is essentially a remedial intervention, while programs to prevent ex-offenders from committing further offenses are considered preventive interventions. Treating an asthma attack or a drug overdose are also remedial interventions, while providing information on using inhalers or access to drug abuse rehabilitation programs are preventive interventions. Unfortunately, while preventive interventions can improve outcomes and save money down the line, they are more likely to be subject to funding shortfalls and budget cuts than remedial interventions, which provide critical services to already-vulnerable populations.

Government agencies at all levels face a similar set of problems around providing social services. Most government funding streams pay upfront for activities that are often tightly proscribed, with strict rules on how the funds can be used and sometimes-onerous reporting requirements. These funding streams, however, often do not require any sort of evaluation of whether the program has been effective.

Agencies find it structurally challenging to think beyond the so-called “silos” of different programs. A juvenile offender, for instance, may receive some services through the corrections department, others through a youth-services program, and still others through the school system. These different programs, each in their own silos, often do not share data or coordinate their efforts effectively. Many government agencies struggle to identify and scale programs that have been proven effective, and it can be difficult to direct funding away from so-called legacy funding streams that have existed for decades but may not work well to newer, more effective programs.

Social impact bonds alter the incentive structure to address many of these challenges by making payment entirely contingent on proven success. Preventive, evidence-based interventions are the most viable candidates for financing through a social impact bond since effective preventive services can reduce the need for more expensive remedial care down the line. The external organization with which the

government agency enters into a contract is incentivized to blend different kinds of interventions to best achieve the desired outcome, effectively circumventing the aforementioned silo problem as many different entities are forced to work together. A rigorous evaluation is likewise baked into the social impact bond structure, eliminating the problem of not knowing whether an intervention has been successful.

Meanwhile, outside of government, nonprofit providers often find it challenging to scale their effective programs because much of their funding consists of relatively short-term grants with fairly rigid reporting requirements. In a social impact bond, these service providers receive multiyear funding commitments with upfront working capital that the external organization collects from outside investors, allowing the service providers to effectively scale their services to reach more people.⁵

Socially-minded trusts and foundations recognize that they do not have enough traditional grant-making capital to resolve longstanding, complex, and pernicious social problems, which is why such organizations find the social impact bond structure appealing. This has the potential to unleash private-sector capital in the social space. Increasing numbers of private investors are expressing an interest in “impact investing,” looking for so-called “double bottom line returns”—financial returns on their investments, coupled with measurable social benefits.⁶

While social impact bonds alone will not wholly resolve these challenges, they serve to show that these seemingly intractable problems are not entirely insurmountable.

Who originates a social impact bond?

In the original model, social impact bonds are generally originated by a government agency at any level seeking to accomplish a very specific goal in a public policy area. The government defines what that desired outcome is, and then partners with an outside organization that will oversee the implementation of the arrangement and will be paid upon attaining the outcome.⁷ In many cases, it will be most appropriate for government agencies to take an active role in originating social impact bond agreements, particularly in service areas where the government has a legal or moral responsibility for the well-being of the population and stands to benefit from any cost savings.

An example of a government-originated social impact bond might be an initiative to stabilize families in order to prevent child abuse and neglect, thereby reducing

caseloads in the foster care system. In this case, the government would define the outcome as a reduction in the rate of nonemergency foster care placements, and the external organization may use interventions such as family-focused therapy to achieve that outcome. At-risk children and adolescents are among the population groups for which most governments have strong responsibilities.

The source of the initiative, however, may vary depending on the nature of the intervention, the target population, and the kind of investment. While the government will often act as the originator, it is also possible for service providers or intermediaries to partially design a social impact bond before the government will accept the idea and agree to buy in. In these cases, the government should take care to assess whether the proposed outcome measures are sufficiently stringent and whether the proposed outcome payments are appropriate.

Governments, for instance, are generally not legally responsible for adults who have become chronically homeless, but the government nevertheless incurs extraordinary health care costs when homeless people repeatedly visit hospital emergency rooms. Many nonprofit organizations and their funders have missions to prevent homelessness, however, and they may be in a better position than the government to initially propose social impact bonds that would advance their missions, reduce the rate of chronic homelessness, and reduce government spending as a result.

Regardless of which party takes the initiative to propose or initially design a social impact bond, the government, service providers, and investors must have matching interests in order for these agreements to work. The transaction cannot take place unless all the parties involved also agree to the terms of the arrangement.

There are some cases in which a social impact bond may be negotiated almost entirely outside of government.⁸ In cases where a nongovernmental entity has some degree of responsibility for the well-being of a certain population, they may be able to originate a social impact bond deal with an outside organization. One such example would be if a health insurance company covering a particular population wanted to reduce the rate of emergency room visits, hospital readmissions, or asthma emergencies. They may choose to set up a social impact bond to have nonprofits run preventive interventions that focus as much on community or home-life factors—such as helping patients keep track of medications and appointments or teaching parents how to help their children use inhalers—as on what we traditionally think of as “health care.” Since the health insurance company is responsible for the health of its enrollees and is the organization for which most

cost savings would accrue in the event of improved health outcomes, it may be a more appropriate originator of the social impact bond than the government.

What is an outcome?

An outcome is a narrowly defined and empirically observable result of public policy. An outcome is not a common platitude such as “improve schools” or “reduce poverty.” The easiest way to define an outcome is to consider examples. A desired outcome of a national program to reduce urban homelessness, for example, could be a 20 percent reduction in the number of people living on the streets over seven years in a city with a large homeless population—a narrowly defined and empirically observable target that could be achieved using any number of strategies

How are social impact bonds different from existing performance-based programs?

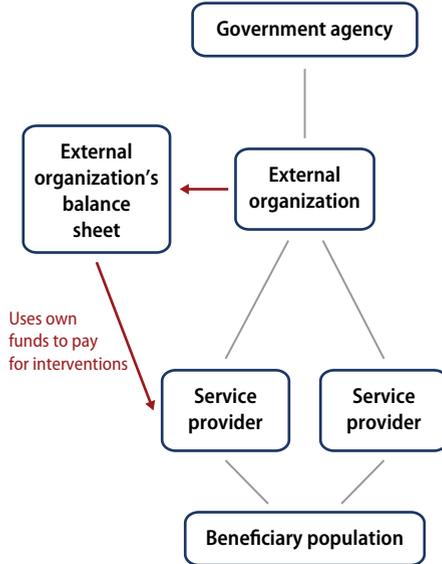
The idea of performance-based contracts is not new, but social impact bonds are a very specific and high-stakes instrument.

Many existing performance-based contract programs essentially provide bonuses for completing contracted work early or under budget or for achieving specific performance targets. Some performance contracts also levy penalties for negative results. In these programs, the contractor still receives significant payment—often as much as at least 80 percent of the total amount even if performance goals are not met. Under the terms of a social impact bond, however, the government is not obligated to pay any money until and unless the desired results are achieved.

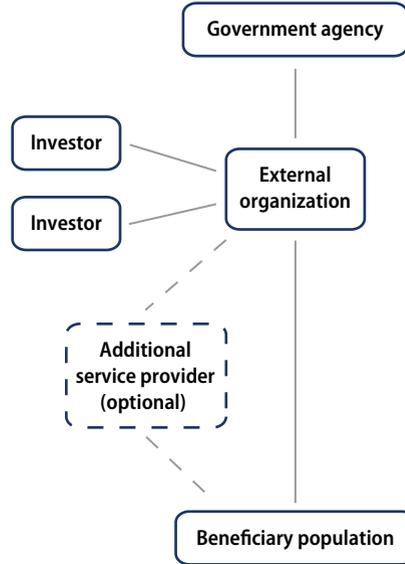
Social impact bonds also do not tell contractors exactly how they can and cannot go about achieving a desired outcome. Many performance-based contracts are primarily contracts for the purchase of goods and services, with adjustments in the payment formulas to reward efficiency. Under many of these contracts, the government proscribes in great detail what products it wants to buy or how the services are to be delivered. Social impact bonds, on the other hand, require the government to place minimal controls on the way the external organization accomplishes the outcome to allow for flexibility and innovation.

Are there different possible designs?

Self-capitalized social impact bond



Self-implemented social impact bond



Are there different possible designs for a social impact bond?

There are potentially many possible designs for social impact bonds, but there are also at least three defining characteristics.

1. Social impact bonds must set a specific, empirically verifiable outcome to be achieved relative to a certain population.
2. The initiating party of a social impact bond contract—usually the government, but potentially a nongovernmental organization—releases payment to the external organization for the outcome if, and only if, the outcome has been achieved.
3. Social impact bonds require considerable latitude for the external organizations to determine, procure, and manage the interventions it will employ as it seeks to achieve the outcome.

Beyond these characteristics, social impact bonds could be arranged and negotiated in a variety of ways. For instance, a well-capitalized external organization could finance the social impact bond itself, with the operating costs coming from that organization's reserves. This would eliminate the need to turn to third-party investors to provide working capital for the interventions. An external organization could also hire multiple service providers to employ different types of inter-

ventions to achieve the desired outcome. An external organization itself could alternatively serve as a service provider, staging an intervention directly.

Social impact bonds could also originate outside of the public sector. A health insurance company, for instance, has an interest in ensuring that the population is healthy; this will decrease its liability for expensive treatments. An insurance company could therefore enter into a social impact bond with an external organization to lower the hospital-acquired infection rate in a given city, and pay for a successful outcome with the money saved from fewer payments for the treatment of those infections.

Some social impact bonds may track multiple outcomes or contain provisions releasing portions of the overall outcome payment when interim targets are achieved and verified.⁹

Beyond the basic requirements of a social impact bond arrangement—achieving a real, measurable outcome paid for if and when the outcome is achieved—there is no right or wrong way to design a social impact bond. A major point of the concept is to encourage new approaches to tackling social problems in government, and that extends to the design of the social impact bond itself.

Who are the investors?

Investors interested in social impact bonds represent a wide array of institutions, foundations, and individuals looking for new ways to solve social problems. These investors are generally looking to generate both social impact and financial returns on their investments. In the nascent social impact bond market, initial financial returns to investors are likely to be modest and not adjusted for risk. Investors who prioritize social return are therefore among those best suited for early use of this model, since there is a chance they will lose 100 percent of their investment. Investors must also be:

- Amenable to long-term pay-out time frames of three years to five years or longer
- Comfortable with the government's commitment to make payments
- Have a high tolerance for risk, including principal loss and lack of liquidity
- Interested in public-private partnerships
- Interested in addressing the program areas social impact bonds address (for example, homelessness, criminal justice, workforce development, health care, etc.)

Philanthropic organizations have shown the most interest in the very first social impact bond projects in the United States and the United Kingdom.¹⁰ In the United States, some banks have also expressed interest in investing in social impact bonds.¹¹ As the market develops, however, we expect that investment offerings will become more standard, transaction structures will mitigate risks, and more individuals and financial institutions will therefore enter as investors.

How much money is usually involved in a social impact bond agreement?

Initial social impact bond projects and those under consideration for 2013 represent a range of monetary investments. The first social impact bond contract in Peterborough, United Kingdom, raised £5 million in investment in 2010, or just more than \$8 million; the first in the United States, in New York City, totaled \$9.6 million in investment in 2012.¹² The Peterborough social impact bond allows for a maximum 13 percent return for investors, while the New York City social impact bond contract establishes a specific sliding scale of payments to the intermediary between \$4.8 million and \$11.7 million, based on the level of achieved reduction in incarceration.¹³

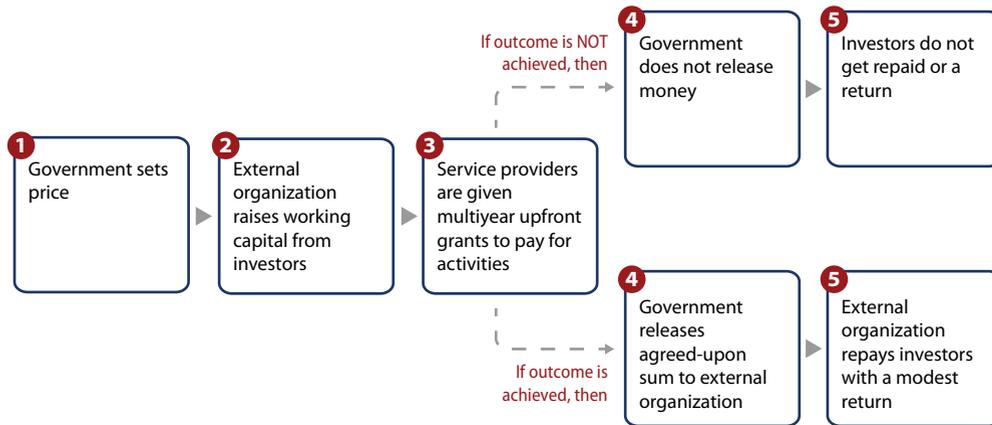
Social impact bonds are likely to be larger than most philanthropic grants because the tools are designed to fund longer-term interventions that scale up proven programs. At the same time, social impact bonds are still an untested mechanism and require more upfront planning and coordination than most grants and government contracts. Because of the precision with which outcomes must be defined and due to the work required to rigorously evaluate whether those outcomes have been achieved, we anticipate that few early social impact bonds will involve more than \$20 million.

Why should investors put money into a social impact bond agreement?

Social impact bonds present an opportunity to scale interventions and programs that have shown evidence of positive impact. These tools are meant for investors interested in achieving both social impact and modest financial returns. Investments in social impact bonds represent a unique opportunity for investors to:

- Generate significant social impact in a variety of issue areas, including homelessness, criminal justice, workforce development, health care, and other social welfare areas
- Help demonstrate a potentially transformative model for financing effective social programs
- Possibly receive modest financial returns

How does the money flow in a social impact bond?



What happens to an investor’s capital when it’s paid into a social impact bond agreement?

Capital from investors ultimately funds operating expenses for the delivery of preventive or early intervention social service programs. Depending on the structure of the transaction, capital can either flow through an intermediary institution that aggregates and deploys funds—what we call the “external organization”—or it can go directly to the nonprofit organizations delivering the services.

Are monetary returns guaranteed?

Levels of guarantee and risk will differ depending on the contract structure. Returns are not typically fully guaranteed. If the agreed-upon social outcomes are not achieved, the government generally will not pay back principal or additional

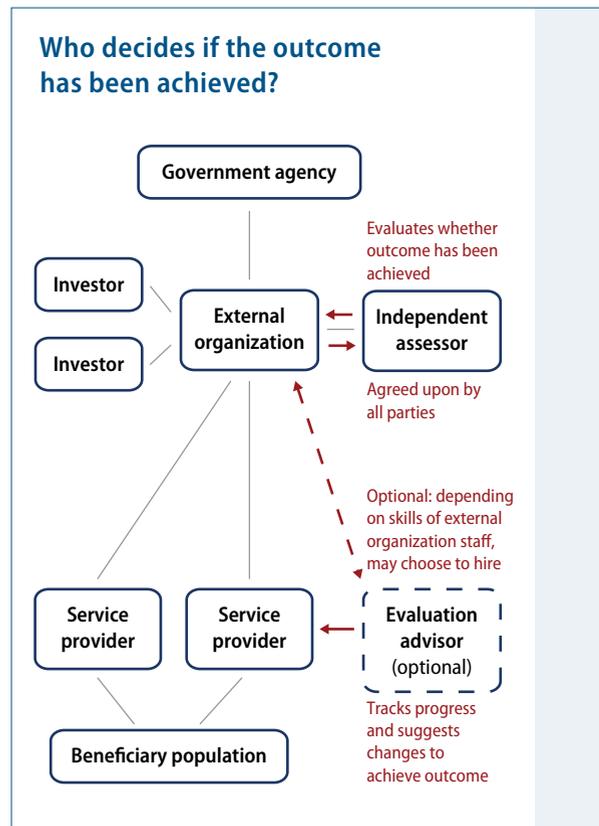
returns to investors. Some agreements, however, are emerging with partial guarantees—as is the case with the New York City social impact bond, in which the investors stand to recoup \$7.2 million of their \$9.6 million investment should the deal fail—or sliding scale pay-out agreements, which provide greater returns for achieving higher-than-minimal outcome thresholds.¹⁴

How do you know if the outcome has been achieved? Who decides if it has been achieved?

At the outset of each social impact bond agreement, all parties should agree on an independent third-party assessor who will ultimately be responsible for deciding whether an outcome has been achieved. The social impact bond contract should clearly establish how data should be collected throughout the lifespan of the social impact bond so that the assessor can conduct an accurate, credible, and rigorous evaluation at the conclusion of the agreement. The outcomes being measured will be unique to each social impact bond agreement and should reflect past research and assessments of the effectiveness of the given interventions being used. For this evaluation to be properly designed and executed, the government must agree to provide the external organization that is managing the intervention with the necessary internal data and access to the population being served.

When throughout the life of the bond should outcomes be tracked?

The intermediary should track progress toward the desired outcomes during the intervention period of the social impact bond. In some cases, an intermediary will not have the capacity to track progress on its own, so it may retain an outside evaluation advisor to work closely alongside the intermediary and service providers to track progress and raise any issues that may lead to a failed outcome. This form of monitoring—sometimes referred to as “performance management” or “developmental evaluation”—will allow for mid-course corrections that can mitigate any unforeseen obstacles to achieving the desired outcomes.



Who gets the money that the government saves? Does government have to use these savings to pay investors? If so, what's the point?

A portion of any financial savings that result from an outcome being successfully achieved will be used to pay back investors for sharing the risk and providing the upfront capital to get the initiative off the ground. This new source of funding would otherwise not be available to expand preventive programs. The balance of savings remains with the government to be used as it sees fit—to scale up more preventive programs, fund underserved constituents, or redistribute to other priorities. Additionally, since the programs being scaled up through social impact bonds are preventive interventions, there are real social-impact benefits for constituents and communities that go beyond any financial savings.

What is an intervention?

An “intervention” can best be understood as an effort to influence or alter a situation in order to achieve a desired result, a mode of working to effect social change, or a specific program activity or therapy.

What are some policy areas that could benefit from using social impact bonds?

Currently, the most attractive policy areas for social impact bonds are:

- Program areas where outcomes can be well defined, and administrative data are available
- Preventive interventions that cost significantly less to administer than remedial interventions and thus have the potential to save government money
- Areas where some proven interventions already exist, particularly those that are politically sensitive or politically unpopular
- Issues where political will for funding can be difficult to muster and/or sustain

Examples of issue areas that fit these criteria include chronic homelessness, persistent recidivism, and youth violence. But there is also considerable interest in using social impact bonds in areas such as early childhood education, international development, and preventive health care.¹⁵

What are some limitations to social impact bonds?

Social impact bonds are not a comprehensive solution to financing social service programs. They should be used where there is evidence that some interventions have worked to achieve the outcome, where an outcome can be clearly defined, and where the government and investors are each willing to take some risk. For government, the risk is in ceding considerable control over the interventions to intermediaries and service providers. The financial risk is borne by the investors, who stand to lose up to 100 percent of their capital if the social impact bond fails.

There are many limitations and challenges inherent in the social impact bond model, including:

- **Timeframe.** Social impact bonds are fairly long-term instruments, with the contracts typically lasting between three years and seven years.
- **Scope.** The government needs to be able to clearly define the desired outcome before originating a social impact bond agreement. The service providers must be able to track their service recipients against that outcome throughout the life of the structure.
- **Termination risk.** If the external organization comes to believe that they will not be able to achieve the outcome and therefore will not receive payment from the government, it might not be able to complete a social impact bond contract. Because of this risk, social impact bonds should not be used to provide essential government services—such as primary and secondary education, or public safety—and mechanisms for orderly termination of a social impact bond agreement should be built into the contract.
- **Costs.** Social impact bond agreements are likely to cost more than a direct contract between a government agency and a social service provider because the intermediation and evaluation layers create additional costs. All parties, including investors, need to understand the benefits of these additional costs in order to deem a project worthy of the structure.

Have social impact bonds been used outside of the United States with any success?

Not yet. The world's first social impact bond was launched in the United Kingdom in 2010, targeting a 7.5 percent reduction in recidivism at Peterborough Prison over four years, compared to similar inmates across the United Kingdom. The intermediary's one-year report noted certain operational improvements, but the recidivism rates for the first group of ex-offenders—the desired outcome—will not be known until 2014.¹⁶

There are also a number of other pending social impact bond proposals in the United Kingdom and elsewhere. The U.K. city of Manchester has voted to use social impact bonds to fund intensive foster care, and East London plans to pilot social impact bonds to reduce the number of young adults who are not in education, employment, or training.¹⁷ Meanwhile, the government of New South Wales, Australia is developing social impact bonds for use in its foster care system and to reduce recidivism rates.¹⁸

What happens if the outcome is not achieved?

If the outcome is not achieved, the government agency does not release payment, and investors will forfeit up to 100 percent of their investment. In some cases—as in the New York City social impact bond—foundations may provide a partial guarantee to private investors such that investors only lose a portion of their principal should a social impact bond deal fail.¹⁹ Some social impact bond agreements may also be structured with intermediate outcome measures, in addition to a final overall measure, which may in turn trigger interim payments even if the overall outcome is not yet achieved.

Failing to reach the outcome in a given social impact bond agreement should not be taken as absolute proof that the model is flawed or that it's impossible to pay for results in the program area. Government agencies should carefully assess why the outcome was not achieved in a given social impact bond agreement. Were the outcome levels too stringent to be accomplished in the amount of time allotted? Did the external organization select the wrong service providers to accomplish the outcome or devote insufficient resources to monitoring their progress? Did the external organization underestimate the costs of providing services and therefore not raise sufficient capital? Was there some change in the beneficiary population

outside of the external organization's control? Did government fail to provide necessary administrative data or fail to allow the external organization to access the population in order to achieve the outcome? Depending on the answers to questions such as these, the government agency may choose to negotiate a new social impact bond agreement targeting similar outcomes.

What happens to the money if the outcome is not achieved?

If the outcome is not achieved, the government agency does not release payment, and investors will forfeit up to 100 percent of their investment. In some cases, as in the New York City social impact bond, the investors' capital may be guaranteed by a philanthropic loan.²⁰ In that example, the loan guarantee would function to repay a portion—but not all—of the investment.

Since service providers are funded through upfront, sometimes multiyear grants, their finances should be unaffected by the failure of a social impact bond agreement.

What happens to the population being served by a social impact bond if the outcome is not achieved?

The contract should include protections for the population(s) served and outline the steps to be taken to wind down services in an orderly and responsible fashion. Vulnerable populations should not be hurt in the event that a social impact bond fails.

What happens to a social impact bond agreement if the political party in power changes after an election?

Investors will want to understand their political risk prior to signing a contract, so they will want to be assured that they will be paid regardless of which party or policymaker holds office. The parties involved in a social impact bond agreement should address and mitigate this risk during the contract negotiation process. The initiating government may wish to use the legislative process to establish mechanisms for repayment—for instance, by creating a trust fund to hold outcome payments. Social impact bond agreements will likely include clauses allowing either the government or the external organization to terminate the agreement under

strictly defined circumstances.²¹ These clauses, however, can make ending the agreement early an unattractive prospect for the government by assigning significant cash penalties for termination.

But social impact bonds have been received with bipartisan support and interest, so there is little reason to expect a change in political party to result in the dismemberment of the contract or structure.²² That's because social impact bonds offer something for politicians on both sides of the aisle. For good-government advocates of both parties, the extremely robust performance measures inherent in social impact bonds provide a true mechanism for governments to pay only for results in some social programs and save taxpayer money if the programs fail. For liberals who want to see an increase in the number of preventive interventions receiving government financing, social impact bonds offer a mechanism to scale up proven preventive programs without requiring cash-strapped government agencies to take on all the risk. For conservatives who believe that governments lack the incentives to make cost-effective decisions, social impact bonds offer a means to bring private-sector-inspired decision making—as well as private capital—into the provision of social services. For these reasons and others, there is little reason to believe that social impact bonds would not survive a change in the party in power.

Questions from government

What are the prerequisites for starting the social impact bond process? Where and how should the process start?

Senior government leadership commitment is an important prerequisite for starting the social impact bond process from inside government. Preliminary research and thinking can certainly be undertaken at lower levels in an agency, but the ultimate successful negotiation of a social impact bond depends on buy-in from senior government officials. Social impact bonds represent a new way of doing business that will require the government to accept new flexibilities in contracting, administration, and financing, all of which will require support from leadership. While nongovernmental organizations may seek to partially design a social impact bond agreement before finding a government partner, the agency or body that will be providing the eventual pay-out must accept the design and implementation terms of a social impact bond agreement. Without its guarantee of funds, the structure does not hold.

Other prerequisites include defining target programs and populations; acquiring good data on the cost of intervention and the ability to quantify some savings; working with legislatures to ensure adequate financing and contractual authority; working with the provider community to build trust and capacity; and, perhaps most importantly, defining and valuing the anticipated outcomes.

A good place for government agencies to start is by creating an executive-level task force that brings together resources across philanthropic, financial, and service organizations, as well as within government, to explore target areas, data, funding and contractual challenges, and local capacity.

What programs are best suited for social impact bonds? Do governments need legislative authority to set up social impact bonds in these areas?

Social impact bonds are flexible tools that can be used across many different types of programs. They are best suited, however, to programs that save government money in the long-term and can demonstrate measurable evidence of success. Experimental social impact bond programs are currently underway or being launched in juvenile justice, prison recidivism, workforce development, and homelessness. Areas under consideration for social impact bonds are special education, early childhood education, veteran's services, and energy efficiency, among others.

It is uncertain whether social impact bonds require legislative authority in all cases. Massachusetts and Connecticut have both enacted legislation related to social impact bonds, but there are considerable differences among state and local governments in their ability to make binding, long-term financial commitments within the scope of current law.²³ It is likely that decisions about legislative and programmatic authorities required for social impact bonds will be made on a case-by-case basis.

How can you pursue outcome-based financing in areas not appropriate for social impact bonds?

Social impact bonds are least applicable in areas where improving outcomes is important but difficult to monetize. It may be more appropriate in these cases to identify key indicators of success and enter into performance-based contracts that reward achievement of these indicators.

How can you mitigate the potential problems posed by term limits and election cycles in social impact bond agreements?

There are two main avenues for mitigating risks related to election cycles in social impact bond agreements.

1. Establishing clear contractual terms when drafting a social impact bond agreement that bind all parties to predetermined outcomes, measurement methodologies, timeframes, and payment terms²⁴
2. Establishing budgetary and legislative support for the deal

Budgetary support could include mechanisms enabling the multiyear obligation of funds or the creation of dedicated trust funds for outcome payments. Legislative support could include laws establishing guaranty or other legal obligations tied to the social impact bond agreement.

What are the key terms that need to be contained in the structure of a social impact bond deal?

In a pure social impact bond agreement, the government will be party to one primary contract—a contract between the government agency and the external organization. Depending on the terms under which the independent assessor determining if the outcome has been achieved is retained, the government agency may also be party to a contract with that group. The external organization should take responsibility for structuring contracts with investors and service providers.

In a social impact bond agreement between the government and an external organization, the contract should, at minimum, cover the following:²⁵

- Broad responsibilities for both parties, including detailed expectations establishing a working relationship between the government and the external organization
- The timeframe for the agreement and the population to be served
- The outcomes and how they will be measured
- The outcome payments, how they will be calculated, and how and when they will be disbursed
- Circumstances under which either party can terminate the agreement and mechanisms for an orderly wind-down of the social impact bond
- Methods for resolving disputes between the parties

What happens at the end of a social impact bond or pay-for-success deal? Will government pay for these preventive services going forward after proof of concept?

It's very hard to predict the likely outcome of a given social impact bond agreement. In some cases, government may find that the social impact bond was a catalyst to scale effective interventions that have consistent results. In these cases, it may be more cost-effective for government to take on the role of financing the

interventions directly after the terms of the social impact bond expire. In other cases, the flexibility and incentives inherent in a social impact bond may demonstrate that using this model is more effective than direct government financing.

Is this only about government savings? Is this a cost-avoidance play (pay later instead of pay now)?

Governments should only set up social impact bond agreements in good faith—that is, while payment is delayed until the end of the agreement and contingent upon results, they should proceed under the expectation and hope that they will eventually pay the external organization upon successful achievement of the outcomes. That’s because a successful social impact bond deal means real, measurable improvements in outcomes for a given population. Social impact bonds are not a way for governments to shirk responsibility or to avoid making payments, and they should not be understood as such.

Can social impact bonds be used as a tool to cut government budgets in the near future?

While social impact bonds have the potential to save government agencies money in later years by reducing the need for expensive remedial services, launching a social impact bond—or even successfully concluding one—should not be considered sufficient evidence to make significant budget cuts to a given program area. There are several reasons why this is the case. First, it’s important to remember that social impact bonds are not yet proven tools. While social impact bonds have been launched in the United States and abroad, none of the agreements have concluded and their results are not yet known. Second, as previously noted, social impact bonds are likely to be relatively small in scale—less than \$20 million total over several years. Finally, it’s unlikely that social impact bonds will be used to replace significant portions of current funding streams because of the model’s focus on preventive, rather than remedial, interventions.²⁶

Successful social impact bonds will save government money down the line and improve outcomes in a real, measurable way for a given population. Several successful social impact bond agreements in a row to reduce recidivism, for instance, may eventually reduce the prison population sufficiently enough to close a wing of a prison or even an entire complex. But governments could equally determine that

rather than closing the prison, they will instead keep the complex open and use the space to reduce overcrowding elsewhere in the system. These kinds of decisions will necessarily be made on a case-by-case basis.

How should government recognize a good outcome? Do outcomes have to drive savings? How can government set a value for an outcome?

An “outcome” is a narrowly defined and empirically observable result of a social intervention. In a social impact bond, the outcome needs to be set relative to a specific population over a defined period of time and against a historical benchmark, average, or trend.²⁷ An outcome by definition involves making a real improvement in people’s lives.

While many programs are designed to have specific impacts on the populations they serve, government typically measures their performance based on easily defined activities. Measures such as the number of people served or time waiting in line, for example, provide important data for program management but do little to tell us whether the program is working. Outcomes, on the other hand, are measures that tell us whether the program is working. Workforce programs, for instance, are designed to help people re-enter the workforce and obtain meaningful employment, and as such, the desired outcomes would include employment statistics, pay rates, and retention.

For purposes of measuring success, an outcome needs to be more specific than a typical public policy platitude such as “reduce poverty” or “improve school achievement,” both of which are difficult to measure. An outcome in a social impact bond targeting recidivism, for instance, might seek to reduce the rate of re-offense by at least 10 percent over five years among nonviolent offenders in a certain age group discharged from a given prison or prison system.

Answering the question of what an outcome, should it be achieved, is “worth” requires considering both objective and subjective metrics. Successful preventive programs will often result in future government savings. But government budgets are complex, and savings may accrue to budgets in different agencies or at different levels of government. For instance, a successful social impact bond to reduce chronic homelessness in a city would likely be initiated, overseen, and paid for by a state or local government agency, but the biggest cost driver in caring for the chronically homeless is in Medicaid and Medicare, which are federally funded programs.

What's more, a much-improved outcome for a population may not generate sufficient near-term savings to cover the cost of delivering the intervention, but governments may nevertheless want to improve outcomes in that group for nonfiduciary reasons. Agencies may want to examine how much other city or state governments pay to provide, for instance, early childhood programs to at-risk populations and any available data on the effectiveness of those programs, and then base outcome values in part on that information and in part on anticipated future savings.

What are the roles of the different levels of government in social impact bond agreements?

Typically, a single governmental entity will be party to a social impact bond agreement and be responsible for fulfilling all obligations under that agreement. In Massachusetts and Connecticut, for instance, the agency headed by each state's chief fiscal officer is negotiating the contract.²⁸ By involving the agency responsible for overseeing the entire state budget, social impact bonds may be able to overcome some of the bureaucratic obstacles that arise when complex social programs, including those meant to address homelessness and youth violence, come under the jurisdiction of multiple agency "silos."

Multiple levels of government, however, may be able to participate in the overall social impact bond arrangement.²⁹ A federal grant may be used to provide funds to a state, which in turn may provide funds to a locality to finance a social impact bond agreement. While the locality is the legal party to the agreement, both the state and federal government may have a role in financing, evaluating, and monitoring the project. Depending upon the nature of the federal grant and the legal authorities underlying that grant, funds could be used to finance outcome payments, working capital, planning and technical assistance, or evaluation.

Who are the investors? How does the government engage with investors?

There is no single type of investor. They can be foundations, impact investors, community-development financial institutions, traditional banks, and other financial institutions. In most cases, the government contracts with a nonprofit or for-profit external organization, or an intermediary, which serves as the go-between for government and investors.³⁰ The government will not normally have a direct relationship with investors.

Will this structure default to easy wins and not address those issues and populations that are hard to reach? Do we have to worry about “cream-skimming”?

Social impact bonds should be structured to ensure the proper alignment of incentives and outcomes and may include provisions to protect vulnerable populations. Social impact bond agreements should also address “shut down” procedures to ensure that participants are not harmed if the project is not likely to achieve its objectives and programs are terminated prematurely. These are important factors for the government agency to consider at the outset.³¹

So-called cream-skimming—deliberately choosing to work with the easiest cases in a population—is a common problem in social programs and can skew an evaluation of the program’s effectiveness.³² But the incentives inherent to social impact bonds may make cream-skimming less likely rather than more likely. Expanding effective preventive programs for the hardest-to-serve target populations can potentially reduce demand for the most costly remedial programs—such as prisons and acute health care services—thereby saving more money in the long run. Carefully and precisely defining the population expected to be served in a social impact bond will also help prevent cream-skimming.

How do we address considerations of entrenched interests?

Social impact bonds, similar to any other community project, will require some negotiation to address the needs and concerns of all interested stakeholders. The primary objectives of social impact bonds, however, are to find new ways to achieve better outcomes for target populations and to foster improved accountability for achieving these outcomes. Social impact bond developers are encouraged to engage stakeholders early on in the project to identify and address critical issues.

From a budgetary perspective, do governments need to obligate the full amount of funds that the social impact bond will potentially require at the outset of the agreement?

In most cases, governments will likely need to obligate all of the funds for an outcome payment prior to entering into a social impact bond agreement. That’s because government budget policy typically requires that funds be available prior

to entering into a contract. In some cases, multiyear contracts are contingent upon availability of funds. This structure, however, would increase investor risk by not guaranteeing the availability of funds to pay out for a successful agreement and therefore would not be appropriate for social impact bonds.

In most cases, governments should expect to obligate the full amount of funds for a successful outcome upfront or make a binding multiyear commitment to appropriate the funds in stages. Similarly, governments will typically need to obligate sufficient funds to pay for the highest possible level of outcome even if the expectation is that this level will not be fully met. As governments gain experience with the social impact bond model, it is possible that some agencies would develop the ability to budget for and obligate an actuarial estimate rather than the highest level.

An exception could be made for some program funds authorized by law. In these cases, Congress has authorized the expenditure of funds based upon participation of eligible recipients. Without specific authority, however, there may be limited opportunity to apply these funds to preventive services offered as part of a social impact bond because of how individual statutes are currently worded.

What kind of flexibility from regulatory reporting requirements is available under federal grants being used for social impact bonds?

This will vary from program to program and between levels of government. In some cases, agencies may have authority to waive certain administrative requirements, including reporting requirements.

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Are social impact bonds just privatization by another name?

Because of the involvement of private investors and the latitude afforded to the external organization by the government to choose interventions and service providers, some critics have expressed concern that social impact bonds represent a new form of government privatization, with the government ceding responsibility for vulnerable populations to nongovernmental organizations that stand to profit.³³ This belies a misunderstanding of the social impact bond model, however, particularly of how incentives work in social impact bonds and in true privatization models.

First, social impact bonds do not eliminate a governmental role, nor do they take responsibility for the well-being of a population entirely out of the government's hands. Government agencies at all levels already commonly contract out many social services. Social impact bonds are new tools for governments to utilize so they can explore new areas of social service provision without shouldering 100 percent of the financial risk of doing so. Government isn't absent in a social impact bond—it is simply making smarter choices by using a limited tool in some preventive social service areas and allowing organizations to have more freedom in designing their programs.

Second, the incentive structure of a social impact bond necessarily means that whatever outcome is being targeted will do something to improve the lives of the population being served in the agreement. Consider that in a social impact bond aimed at reducing recidivism, the incentives for all involved are to prevent ex-offenders from re-entering the corrections system. In comparison, when prisons or other parts of the corrections system are privatized, the incentive for the organization holding the contract is to ensure that they have a steady supply of prisoners, so they continue receiving payment with an eye on maximizing profits.

While investors do stand to receive a modest financial return if a deal is successful, without social impact bonds, there wouldn't be as much incentive for nonphilan-

thropic funders to provide working capital to achieve social outcomes. Social impact bonds’ “double bottom line”—a small return on an investment coupled with quantifiable social goods—serves to incentivize that investment.

Can government only participate in social impact bonds as a payer for results? Are there hybrid models? Can the government also be a service provider?

There are a range of models that fall under the broad rubric of “pay for success.” These include social impact bonds, HUCAPs/Minnesota Bonds, and variations on these themes.³⁴

In developing hybrid models, it is useful to keep the desired goal in mind—to address elements that aren’t working in the current system, and to invest in programs with evidence of success. Particular problems that might be addressed by hybrid approaches include the current policy focus on remediation rather than prevention, loyalty to legacy programs even when better evidence-based programs are developed, and failure to take new, high-value programs to scale. If hybrid models don’t address such issues, then there is not much utility in creating new approaches to “pay for success.”

Nonprofit organizations currently play a significant role in providing direct social services. Government employees do not directly deliver many social services, instead providing funding that pays nonprofit providers to run homeless shelters, foster care systems, and after-school programs. If government wants to take on the role of paying for performance, then outsourcing direct service provision to nongovernmental organizations continues to make sense. It would be challenging for one part of government to provide services and another part of government to opt out of paying for them if the first agency fails to deliver results.

Are there general techniques to address the complexities of accounting for savings over a multiyear period across multiple programs and agencies? Are there true savings for government? Can savings be shared?

There is a better way to manage social impact bond savings than by getting into the weeds of accounting across multiple programs and agencies. The recommended

approach for managing savings is to confirm in the upfront planning and structuring stage of a social impact bond that if an agreed-upon set of social outcomes are achieved, there will be savings on remedial programs currently provided. By monitoring and measuring whether the social outcomes are being delivered, social impact bond stakeholders will know if savings are being generated for the system. Doing this analysis upfront relieves the social impact bond process from trying to control savings across multiple programs and agencies over multiple years. Furthermore, this approach accurately reflects that yearly savings will typically be redirected rather than aggregated, and that some social impact bond benefits will be in the form of future cost avoidance rather than savings in a current year.

Are there general techniques to expedite cost-benefit analysis of programs in cities/states?

The Pew Trusts program, Results First, is working to bring the cost-benefit analysis approach for social programs developed at the Washington State Institute for Public Policy to all 50 states.³⁵ This will help jumpstart social impact bonds' structuring by identifying top evidence-based programs and doing fundamental analysis on the marginal costs and benefits such programs offer compared to the status quo on a state-by-state basis.

What evaluation approaches are most cost-effective, rigorous, and suitable for programs scaled via social impact bonds? Do randomized control trials need to be used?

Multiple evaluation methods have the potential to be rigorous and cost effective. For a social impact bond to be successful, there must be an agreement upfront about the kind of evaluation that will be required so that the deal can be appropriately priced. The evaluation method should be chosen according to specific project requirements, taking into account the timeframe of the agreement, the issue area, and the availability of public data. Randomized control trials are one option, and researchers have shown it is possible to conduct high-quality randomized control trials at low cost.³⁶ The costs of administering a randomized control trial can be reduced by measuring outcomes with administrative data that has already been collected for other purposes, such as student test scores, criminal arrests, and health care expenditures.

There will be instances where randomized control trials are impossible or inappropriate to use. But other evaluation methodologies can still be sufficiently rigorous to satisfy government, investors, and evaluators that an outcome is valid. One such methodology is known as propensity score matching. It is the method being utilized in the Peterborough social impact bond.³⁷ Propensity score matching establishes a control or comparison group against which results of the intervention can be measured.

How do we trust that intermediaries bring together the right service providers? What is the due-diligence tool?

Intermediaries bear significant financial and reputational risk in social impact bond projects and therefore are incentivized to partner with the most effective service providers. The Capabilities Due Diligence Tools were developed by McKinsey & Company and the Nonprofit Finance Fund and provide a detailed framework to assess the core capabilities for participation in a social impact bond transaction.³⁸ These tools are meant to support advanced discussions, lay the groundwork for collaboration among multiple stakeholders, and help assess and mitigate risks. The tools are designed to be used over a 12-week due-diligence process, are highly customizable, and can be adapted to a modified timeframe or streamlined with other due-diligence processes to fit local project needs. They are available at the Nonprofit Finance Fund's Pay For Success Learning Hub.³⁹

Are there any models to set outcome values?

Answering the question of what an outcome is “worth” should it be achieved requires considering both objective and subjective metrics. Successful preventive programs will often result in future government savings. But government budgets are complex, and savings may accrue to budgets in different agencies or at different levels of government. Agencies, for instance, may want to examine how much other city or state governments pay to provide early childhood programs to at-risk populations and any available data on the effectiveness of those programs, and then base outcome values in part on that information and in part on anticipated future savings. Significant research still needs to be done to better understand how best to value outcomes.

In cases where governments hope to primarily or solely set outcome values based on anticipated future savings, various models exist to measure cost savings in the

achievement of social outcomes. Parties structuring transactions should consider leveraging the existing evidence base and research on intervention models. Several organizations have established standards for measuring outcomes and assigning monetary value, including:

- Coalition for Evidence-Based Policy’s Social Programs That Work⁴⁰
- Blueprints for Violence Prevention⁴¹
- Child Trends LINKS (Lifecourse Interventions to Nurture Kids Successfully)⁴²
- Communities That Care (CTC)⁴³
- Office of Justice Programs’s CrimeSolutions.gov⁴⁴
- Office of Juvenile Justice and Delinquency’s Prevention Model Programs Guide⁴⁵
- Promising Practice Network (PPN)⁴⁶
- Washington State Institute for Public Policy (WSIPP)⁴⁷
- Annie E. Casey Foundation Evidence-Based Programs⁴⁸
- Outcomes and Effective Practice Portal from the Urban Institute, Child Trends, and Social Outcomes (Work in Progress)⁴⁹
- Vera Institute of Justice⁵⁰

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