

Report on the

NSW GOVERNMENT

Social Impact Bond Pilot

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JBWere



THE YOUNG FOUNDATION

The views expressed in this Report are those of the Centre for Social Impact. We have benefitted considerably, however, from the professional legal and financial advice provided by:

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- JBWere
- Macquarie Group
- Young Foundation

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Executive Summary

Traditional ways of funding not-for-profit organisations (NPOs) to deliver programs that address complex social problems are struggling to keep up with demand. Despite record high levels of government funding for NPOs, there is still a significant level of unmet need and new approaches to funding NPOs are being explored.

There is increasing international interest in the potential of one particular type of social finance – social impact bonds (SIBs). SIBs, it should be emphasised, are not a panacea. Their use should complement existing modes used to fund community benefit goals.

In this report, the Centre for Social Impact (CSI) has addressed two key questions:

1. Whether the SIB concept is feasible in a New South Wales (NSW) context; and
2. Whether NSW has the necessary ingredients: market conditions, NGO capacity, social investment interest and government preparedness, for this new approach to funding.

To answer these questions CSI has held detailed discussions with and considered the perspectives of NPOs, social investors/philanthropists and government agencies. The overarching conclusions are that CSI believes that the SIB concept is feasible and NSW does have the necessary ingredients, although there is much work to be done to deliver a SIB pilot.

What are social impact bonds?

A SIB restructures the relationships between government agencies, not-for-profit service delivery organisations and social investors such as charitable foundations and high net worth individuals. Under a SIB, a bond-issuing organisation raises capital from investors based on a contract with government to deliver improved social outcomes that generate future government costs savings. These savings are used to pay investors a reward in addition to the repayment of the principal, if the agreed outcomes are achieved.

SIBs support social innovation by providing a mechanism for investors to fund programs based on early intervention, prevention or breaking the cycle of dependence. They offer the potential to achieve significantly better social outcomes and deliver future costs savings for government. SIBs provide a new model for the sharing of risk between government, NPOs and social investors. They utilise commercial investment expertise and market discipline for the delivery of public services by NPOs.

The groundbreaking UK SIB, launched in 2010 by social finance intermediary Social Finance UK, was aimed at significantly reducing the rate of reoffending by short-sentence prisoners through services delivered by subcontracted NPOs. The UK SIB has identified and addressed a number of challenges and in doing so provided valuable learning, including the recognition that it constitutes only one model and is operating in the cultural context of one jurisdiction and one policy area. A number of initiatives around the world are now considering the wider applicability of SIBs including this study by CSI commissioned by the NSW Government and further pioneering work in the UK by the Young Foundation. These initiatives are exploring the suitability of other policy areas, the feasibility of an NPO issuing the bond as an alternative to using a social finance intermediary, the merits of different levels of risk sharing, and use of a standing payment to cover part of the program delivery costs instead of an entirely performance based payment.

NSW Government SIB pilot

In consultation with a range of NSW Government public servants, CSI has identified a range of policy areas and program interventions that address complex problems and are perceived to deliver significantly better outcomes with the potential for future government costs savings. The policy areas included juvenile justice, parenting support for vulnerable families, disability, homelessness and mental health. CSI investigated the potential programs to assess the evidence of their efficacy and the scale of potential government costs savings. A small number of programs was investigated further to define and measure the desired outcome, target cohort and referral mechanisms, and the effectiveness of the program to achieve the desired outcome(s). These findings were combined with data on program costs and estimated government costs savings to formulate an economic model that could inform the key parameters of a SIB.

CSI has identified a range of NPOs that have the capacity and necessary competencies to host a SIB program and also have the legal powers to issue a bond. The use of a SIB is attractive to an NPO as it provides upfront capital to develop and deliver a program to achieve the agreed outcome over the medium to long term. The use of a SIB frees the NPO from the constraints of traditional government contracts and it distances government from service delivery management and operations. Use of a SIB also provides the basis for the NPO to develop a stronger relationship with social investors which may have long term benefits for the NPO in terms of expanding existing and developing new programs.

CSI consulted with a range of potential social investors and their advisors, who confirmed that there is an appetite amongst investors for the use of SIBs. SIBs offer social investors a method of achieving blended value with both commercial and measurable social return on their investment. A SIB provides social investors with a more effective method of holding an NPO to account in terms of

setting targets and monitoring performance akin to that used in commercial investment decisions. Some social investors interviewed expressed a willingness to invest directly with an NPO as an alternative to investing through an intermediary.

Social investors and their advisors noted that the type and number of investors and the investment decision would be different for a pilot than in an emerging or mature market for SIBs. Social investors with a philanthropic mindset may consider a SIB to be a way of recycling their philanthropic resources, and may therefore be willing to risk their capital, whilst other social investors expressed a preference to protect their capital either in part or full. Some social investors interviewed stated that they could utilise philanthropic resources, private ancillary funds (PAFs) or self-managed superannuation funds (SMSFs) – for the latter there was a strong preference to protect their capital.

Options for the structure of the NSW Government SIB pilot

The consultations with government, NPOs, law firms, financial institutions and social investors have led CSI to believe that:

- a social finance intermediary is not necessary for the NSW Government SIB pilot although this remains an option for future SIBs; and
- NPOs that are incorporated have the powers to issue bonds and may be able to utilise Australian Securities and Investment Commission (ASIC) exemptions to simplify the process. Alternatively NPOs may wish to ring-fence risk by establishing wholly-owned vehicles to issue the bond, such as a special purpose vehicle (SPV).

CSI has developed a range of options for the terms of the bond that illustrates different levels of risk sharing across government, the NPO and the social investors. Where there is a higher risk to the invested capital, the reward will need to be greater, while decreasing this risk will lower the rate of return. The possible rate of return will depend, in part, on the chosen policy area and program intervention, and the extent of the potential savings to government.

At one end of the risk spectrum, CSI proposes a structure which is comparable to the UK SIB where the principal and reward payment (return on investment) to investors is fully dependent on the achievement of a successful outcome and where failure means that government pays nothing. This option is attractive to government as there is a full transfer of risk to the social investor, which is reflected in a higher indicative reward payment.

CSI believes that this option would be attractive to philanthropically-minded investors who are supportive of the development of SIBs. However, the number of investors and scale of investment of this type is limited, but may be sufficient for a NSW pilot.

At the other end of the risk transfer spectrum CSI has developed an option which reflects the preference of some social investors to protect their capital and where only the reward payment is at risk. This option would be attractive to social investors who wish to use self managed super funds but it offers little incentive to government as there is only minimal risk transfer to social investors and the NPO.

CSI has therefore formulated **an option where there is a balance of risk sharing between government, NPO and social investors**. Under this option part of the costs the NPO incurs delivering the program will be paid by government through a standing charge, and the remaining costs and reward payment will be dependent on the achievement of a successful outcome. The exact level of the standing charge will be the subject of negotiation between the NPO and government, where the NPO is not only assessing its confidence in delivering the agreed outcome but is also sensitive to the preferences of potential social investors. Government may wish to minimise the level of the standing charge but will also be aware that the NPO and social investors will have limits. Indeed, government may offer a higher level in order to incentivise NPOs and investors. Such a risk sharing arrangement will lead to a moderate level of reward payments. Social investors interviewed responded positively to this shared risk option and the standing charge. CSI considers that this option will be attractive to not only philanthropically-minded investors but also to a wider group of social investors who are prepared to accept non-traditional terms and new and innovative investment models.

CSI recommends that this shared risk option is considered for the NSW Government SIB pilot. The final structure will depend on the program and host NPO selected and the detailed negotiations between government and the host NPO, and the perceived appetite of potential investors.

Challenges

1. Robustness of evidence and measurement.

The construction, issuing and operation of a SIB are heavily dependent on the robustness of evidence and measurement of the efficacy of program interventions. Evidence and measurement give confidence to government, NPOs and investors that the agreed outcomes can be achieved. There has been increasing emphasis in social programs and social interventions in NSW on gathering evidence on client outcomes, but there remains room for improvement in this area, particularly in terms of accepted robust evidence on intervention effectiveness. The emergence of tools such as Social Return on Investment will assist NPOs,

government and investors to assess risk. However, the discussions with government, NPOs and evaluation experts suggest that many NPOs need to invest in developing more robust and continuous performance measurement systems and evaluation methodologies. Government and NPOs also need to consider how they can integrate administrative and program data.

- 2. Specific capacity building initiatives will be needed to widen access to SIBs beyond the large NPOs that have already invested in research and evaluation capabilities.**

Next steps

CSI has concluded that the SIB concept is feasible in the NSW context, and that NSW has the necessary market conditions for this new approach to funding to be trialled. **CSI therefore recommends that the NSW Government proceeds to the next stage and invites expressions of interest from NPOs that satisfy the key criteria for the development of a SIB.**

The NSW Government should also signal that they wish to encourage the development of a pipeline of NPOs and programs that are suitable for a SIB by raising awareness and developing NPO capacity and capability to use this new method of funding. This will require a special emphasis on development and use of robust evidence in the effectiveness of social programs and interventions, the development of performance measurement systems, and collaborative relationships with government agencies. The raising of awareness among NPOs and capacity building initiatives should be aimed at all sizes of NPO and also social enterprises.

The NSW Government should undertake initiatives to raise awareness across all NSW Government agencies and develop guidelines on how to assess the suitability of policy areas, program interventions and host NPOs.

The NSW Government could also explore the potential for the application of SIBs in policy areas where there is a shared responsibility and shared funding arrangements with the Australian Government. Engagement with the Australian Government also provides an opportunity to consider incentives and barriers in relation to tax issues and the use of capital held in PAFs and SMSFs.

Finally, efforts need to continue to capture knowledge and share learning across jurisdictions.



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