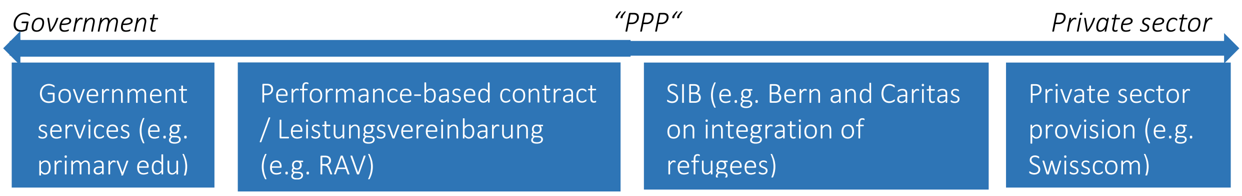
Social Impact Bonds: What, why and how?[1]

This paper gives an overview on Social Impact Bonds (SIB) as a "new" instrument for donors and lists critical questions and factors to consider before setting up a SIB.

1. What is a SIB?

SIBs are a performance-based contract.[2] A social service is pre-financed by private investors while the return is paid by a public or philanthropic entity in case of successful results (outcomes). They provide an attractive option for donors to strengthen effectiveness and efficiency of development projects while shifting risk to private investors. By focusing on results, SIBs also deal with the principal-agent problem, aligning incentives and leaving more flexibility to the implementer on how to achieve these results. This incentivizes innovation and efficiency in achieving desired development results.

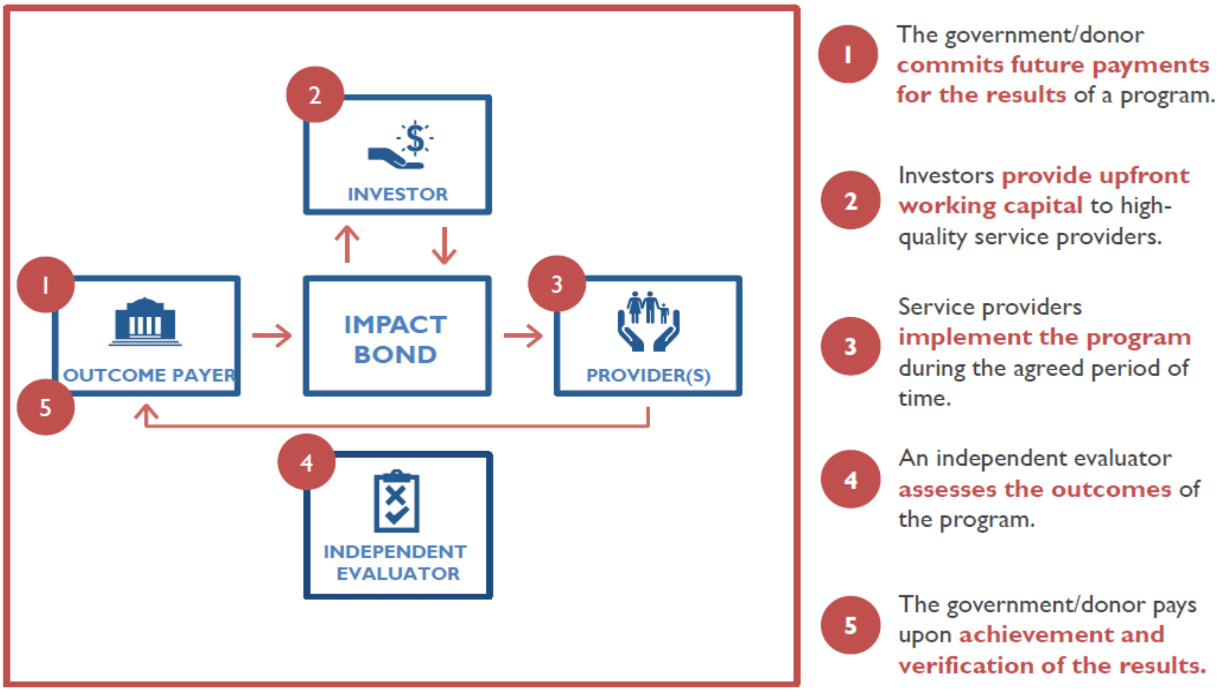
About 50 SIBs have been set up globally, mainly in Anglo-Saxon countries. Most of them focus on social services such as employment training, health, criminal justice, education and child well-fare. SIBs use public supervision of social service provision while incorporating the incentive structure of private providers. A SIB is one form of how governments can provide social services/ programmes. It can be seen as somewhere in the middle of this spectrum (i.e. the partnership area) between services provided and financed by the government itself vs. fully provided and financed by the private sector:



In a SIB, the public entity (government or donor) only pays for achieved results instead of upfront payments for clearly defined outputs as in a traditional mandate. Socially-motivated investors provide funding up-front and get a risk premium (bonus/malus) depending on the achieved results. The risk premium is usually also applied to the implementing agency ("service provider"). A SIB is thus a <u>risk-sharing instrument, which better aligns incentives between donor, investors and service providers, which rewards successful projects while it punishes failures</u>. A SIB does not per se lead to mobilisation of additional funding (leverage), however can help smoothen government expenditures over multiple years. It also ensures against the use of public funds for ineffective programs.

The main motivation for a SIB is a principal-agent and information asymmetry problem between a government or donor who wants to maximize the social return or public good of a project vs. a service provider who wants to maximize the economic return or private good, representing a certain trade-off. For example, in an employment service program, the main motivation for a service provider is to attract as many participants as possible since normally they are reimbursed by the number of trainees. In a SIB setup, the main incentive will be to place as many participants in jobs, if this is the defined results measure upon which the return will be paid. A SIB is therefore an instrument, which aligns incentives in a way that <u>maximizes the sum</u> of the public and private good. The figure below shows a setup of a SIB and the flow of funds.

[1] This is a draft outline for practitioners written by Christian Brändli (SECO) and Luca Etter (SDC). The views expressed herein are solely those of the authors and do not represent an institutional position of SECO or SDC.
[2] In the respective context referred to as *Development Impact Bonds, Humanitarian Impact Bonds* or just *Impact Bonds*. For the sake of simplicity, we use the term Social Impact Bond throughout this draft. Please note that "bond" is a somewhat misleading term, as it is actually an outcomes based contract with up-front investments.



Source: Instiglio

2. What is the motivation to set up a SIB for a particular development intervention?

There are different reasons for using a SIB as an instrument to finance a development intervention.

- Current service provision seems to be inefficient and the incentive structure of a SIB promises to yield **efficiency gains** leading to better development results.
- SIBs **shift the risk to the private funder**. Donors only end up paying for successful interventions.
- As an important side-effect of SIBs, **M&E systems are strengthened** because the final payment depends on well-measured results, which are verified independently.
- SIBs can **spur innovation** to social problems. Donors define the desired result and let service providers decide on the best way of achieving it instead offsetting up a rigid Logframe logic.
- **Service quality is increased** as service providers adapt their implementation strategies without the donor having to be involved in all decisions.
- By creating a competitive market to identify the best service provider, SIBs **improve effectiveness and transparency**.

3. What are the conditions that need to be met for a SIB?

SIBs are a very complex contractual and financial construct. They may make sense in a limited number of specific cases where potential gains are big. The following conditions should be met to consider a SIB:

- The results need to be meaningful and measurable, unlikely to cause adverse incentives, be credibly attributed to the project and can be achieved within a reasonable time horizon. This holds e.g. for the following sectors:
  - Workforce development (e.g. training leads to formal employment registration)
  - Chronic diseases such as diabetes (e.g. treatment leads to stable blood sugar level)
  - Early childhood development (e.g. prevention of mother-child transmission of HIV)
- The donor knows exactly what it wants upfront (e.g. efficiency gains or innovation) but cannot or does not know how to do it best itself.
- An efficiency gain is expected by aligning incentives of service provider with results. There needs to be a valid assumption as to how the efficiency gains can be achieved (i.e. through better partner selection, better contracts, more transparency).
- The context needs to be relatively stable (i.e. context and prices do not change permanently) or can be hedged.

- The target population can be well-defined. Monitoring needs to be feasible and verifiable. Administrative data (ideally) that is credible and readily available can be a cost effective means to achieve this.
- There is scope for innovation in a given field or social service.
- The government shows strong commitment.
- Interventions which tackle the underlying causes of specific social problems and shed light on issues that can lead to systems change are better suited for SIBs.
- There is a potential for scaling i.e. SIBs as a tool for a broader take-up in the market.
- SIBs are not suited for very small projects, as the unit costs may be too expensive.

4. What are the benefits and challenges/ risks?

SIB have clear benefits, but also imply important risks (high risk/high reward instrument)

Benefits	Challenges/ risks
Service providers may have access to new funding, provided they demonstrate a good performance in a SIB	A SIB needs time to be set up, given that several variables (such as price per unit) need to be defined in advance
Service providers are incentivized to develop a data system to track results and implement course-corrections in real time	External factors may compromise some results (e.g. radical changes in target population)
Risk-sharing: the donor is “insured” against funding projects, which do not achieve results	A SIB might create adverse incentives (e.g. only the easiest to integrate into the labour market are trained) if applied in the wrong issue area or if ill-designed or monitored (e.g. wrong price for results)
Improved accountability and performance thanks to clearly measured results linked to payments, leading to more efficient public spending	
A SIB brings all stakeholders around a problem together to define evaluation methods and identify factors for success, which leads to better aligned incentives to achieve results	A SIB may not align with government’s annual budget cycle logic (the payments are only due at the end of a project and depending on achieved results)
Improved collaboration between public and private actors	A SIB is a resource-intensive undertaking due to a complex contracting and governance structure
Leaves more flexibility and room for innovation to the service provider on how to achieve the agreed results	What is measurable might not be the most relevant thing to do and sheds the light on the wrong spot
Once taken off, there may be new results funders (foundations)	The government may end up paying profits to private investors, which is politically hard to sell
Investors support monitoring function and due diligence by outcome funders	Administrative hurdles for the government to engage in a SIB as outcome planning with uncertain financing needed in the future may not align with current public sector financing logic with clear budgets per year
Budgetary room for the donor or government to fund other projects in the short-term as investors provide up-front funding	

Conclusion: A case by case cost-benefit analysis is key to compare the gains from 1) effectiveness/ efficiency and 2) potential scaling and development of a market (taking into account there are various costs that will go down over time) against the high set up costs. Ensure proper safeguards are in place.

5. How to set up a SIB?

SIBs are complex. There are many different ways in setting up a SIB and the devil is in the detail. Important considerations should be taken into account in order to avoid adverse incentives and unintended effects.

Overall considerations:

- Match of issue area and instrument: Consider if the issue area is really appropriate for an impact bond?

- Consider that a lot of resources, skills and political commitment are necessary (from beneficiary government and donor side) to set up a SIB (especially in the beginning).
- Understanding the political economy ("privatisation of social services") and the regulatory environment ("annual budget cycle logic") in the beneficiary as well as the donor country are critical to get a SIB right.
- Exit criteria are key as SIB often cover some of the costs for social programmes that governments would or should provide anyhow. Therefore, supporting a government with co-financing for outcomes, should be limited in time and the government should cover the costs itself once convinced about this "new" instrument or approach.

Technical considerations:

- Ideally the wish to set up a SIB in a certain issue area is driven by governments (and / or donors) and the SIB set up is guided from this perspective (and not from the service providers' or investors' perspective).
- The governance and contract structure should be as solid but simple as possible. Sometimes, no investors are needed but an outcome performance contract with the service provider brings the same benefits in a simpler set up.
- Ideally, the incentive structure does not only provide a risk premium for the investors, but a risk premium (bonus/malus) for the service provider as well. In this case, incentives are truly aligned between the donor and the service provider instead of the donor carrying all risk of a project failure (and success!).
- Usually a tender is carried out to select the most promising service provider (positive self-selection as only the service providers that are convinced they can deliver the outcomes will make a bid).
- Outcome payments per unit and not for an overall, e.g. per worker integrated into the labour market (if absolute numbers are set for overall targets, the service provider might give up soon as the target seems without reach, or the service provider has no incentive to "overachieve")
- Create a maximum ceiling for outcome payments (in order to protect you from sky-rocking success and very high outcome payments) and a possibility to increase it (to keep incentives up).
- Define a minimal threshold for the first outcome payments for those who would have achieved target outcomes anyway (so called deadweight amongst the target group).
- Consider a tariffed approach e.g. higher outcome prices for youth, so that the service provider has an interest to also train people that face more difficulties to get a job. But only consider a top-up if there are strong indications that in the respective context e.g. women find it harder to find a job (because we usually do not want to value a job for a woman higher than a job for a man).
- Consider a mid-term review in the contract with the option of adjusting prices for outcomes in case of a change of context, which triggers changes of outcome costs.
- Rigorous (experimental or quasi-experimental) evaluations are not always necessary for measuring impact and determining repayment but evaluations should be designed as solid as needed to ensure outcomes can be attributed to the intervention (and provide windfall benefits in the case of, say, an rapidly expanding economy).
- Contract design: triggers should be foreseen, i.e. disbursements for future outcome payments are only made once a SIB structure is set up and investors and outcome funds are pledged. Investors will probably need the future outcome funds to be deposited (often a Special Purpose Vehicle) before they provide their upfront funding (due to governments/ donors restrictions/ parliamentary clause for disbursement). A government or donor would need to commit funds to the amount of the ceiling and a clause in the contract should be foreseen in case of remaining funds (reinvested into the project, back to financial administration, part of a second phase). Another option is to provide a sovereign guarantee that payments will be made if outcomes are met.
- Take into account previous "non-success" stories on results-based contracting.
- Importance of systematizing and sharing methodologies and experiences.

6. SECO and SDC Examples

SECO Employability Social Impact Bond Program in Colombia

SECO aims to provide better access to jobs for disadvantaged people in Colombia. Together with the Multilateral Development Fund of the Inter-American Development Bank, it is setting up SIBs in the area of employability. Private investors will provide upfront funding for Colombian NGOs or private sector actors (service providers) to provide trainings for unemployed people. SECO together with the Colombian government will pay for every unemployed person getting and retaining a job (outcome payments for a formal work contract and one year after). The SIBs are expected to incentivize service providers of employability programs to attain better results. At the same time, SIBs leave more flexibility to service providers on how to integrate people into the formal labour market, which might depend on population group and region within Colombia, and adjust trainings accordingly. The program will also contribute to build the necessary data and market environment for SIBs. More broadly, it aims to increase the awareness and knowledge about SIBs for social programs in order to prepare the ground for scaling SIBs.

SDC Social Entrepreneurship Catalytic Impact Financing Facility

SDC (Employment and Income Focal Point) has started a variation of a SIB in 2015 via a multi-bi project with IDB/MIF which has established the Social Entrepreneurship Catalytic Impact Financing Facility for Latin America and the Caribbean (LAC-IMPACT). LAC-IMPACT is an outcome payer that provides payments to social enterprises based on the social contribution generated by their operations. The greater the social contribution, the greater the payments made. This should in turn incentivize investors to fund social enterprises as it makes them an attractive investment target. Since their return on investment also depends on the social performance of the enterprise, incentives of all actors (investors-social enterprise-outcome payer) are aligned.

7. Further literature

Brookings Institute (2015): *The Potential and Limitations of Impact Bonds: Lessons from the First Five Years of Experience Worldwide* (https://www.brookings.edu/wp-content/uploads/2016/07/Impact-Bondsweb.pdf) and *Policy Recommendations for the Applications of Impact Bonds*: (https://www.brookings.edu/wp-content/uploads/2016/07/SIB20Policy20Brief201web-1.pdf)

Center for Philanthropy Studies (CEPS) at University of Basel (2015): *Social Impact Bonds* (https://ceps.unibas.ch/fileadmin/ceps/redaktion/Downloads/Forschung/CEPS_Forschung_Praxis/FP13_CEPS_Social-Impact-Bonds_web.pdf)

Center for Global Development and Social Finance (2013): *Investing in Social Outcomes: Development Impact Bonds* (http://www.cgdev.org/sites/default/files/investing-in-social-outcomes-development-impact-bonds.pdf)

The Economist (2016): *Trending: Blending. The fad for mixing public, charitable and private money* (http://www.economist.com/news/finance-and-economics/21697263-fad-mixing-public-charitable-and-private-money-trending-blending)