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Public, Private, Nonprofit Partnership

A Case Study of Social Impact Bonds

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Can the delivery of quality social services create returns for private investors? Social impact bonds are trying to answer that question. Incubated in the United Kingdom in 2010 as a way of financing programs to reduce recidivism among offenders, social impact bonds have been scaled to 15 countries, across 60 projects by June 2016. The first social impact bond in the United States was executed in August 2012.

Social impact bonds—a financial tool in which private investment dollars lend capital to finance the expansion of human, health, and social service programs that work—tap into core aspects of building a Culture of Health for all Americans. They require a new type of relationships among private investors, government agencies, social service providers, and evaluators. They rest on the provision of high-quality social programs delivered at enough scale to make a broad impact. They are not quick fixes; they rely instead on solid commitment of multiple actors over time.

Three panelists representing an investment firm, an umbrella social services agency, and an evaluation organization explored how Salt Lake City used a social impact bond to expand access to high-quality early childhood education.

Social Impact Bonds: What They Are and How They Work

A social impact bond is not a bond. It is a working capital loan against the proceeds of a pay-for-success contract."—Andrea Phillips

Social impact bonds—also known as pay-for-success financings or outcomes-based financings—have emerged as a tool for government to fund what works and improve outcomes for disadvantaged communities. In a social impact bond, private investment firms provide upfront working capital to help finance the expansion of a social service to a community. Investors are repaid only if the program achieves outcomes specified in the contract. Social impact bonds rest on the belief that prevention and early intervention programs yield both human and financial benefits—they are a triple-win for governments, service providers, and communities.

Investors provide the necessary working capital to bridge the gap between the time when services are provided and the time when the savings that generate repayment are realized. They also take on the risk of impact (i.e., the chance that the social intervention may not produce results in the community).

"Impact investments aim to generate financial returns while simultaneously driving towards a very intentional social impact," says Andrea Phillips. "These social impact bond opportunities are underwritten as any other loan would be, with additional attention paid to social impact."

Essential actors in a social impact bond relationship are:

- A government agency wanting to address a significant social issue such as homelessness, recidivism, or early childhood development
- A private investor willing to front funds for an intervention to address the issue
- An intermediary organization able to sign the loan agreement, contract with service providers, oversee the initiative, and repay the investor
- One or more community-based organizations with proven interventions and the capacity to deliver the services
- An evaluator prepared to conduct a rigorous study of service outcomes and impacts.

This arrangement among multiple stakeholders aligns incentives and holds everyone accountable for results. Government agencies, service providers, and evaluators come together, with the shared goal of achieving broader impact than each could achieve on its own. Impact investments like these have more typically been utilized to finance brick-and-mortar projects that revitalize communities such as local health centers and mixed-income housing. For example, Goldman Sachs has committed more than $5 billion in impact investments such as these since 2001.

Sharing Risk

A core feature of social impact bonds is shared risk, or "pay for success." This notion of risk is new and at times unusual for social service and government agencies whose historical contractual relationships have been and are still generally based on reimbursement for services rendered.

Standard fee-for-service contracts may reduce risk, but they have limitations. They usually pay based on activity measures such as number of people served and types of services provided. While these measures are essential for active program management, they provide little information about whether the ultimate outcomes are achieved and do not directly address the quality of the services delivered.

When there is a large gap between the time during which a service is delivered and the time when government savings or future benefits are accrued from the provision of effective services, an outcomes-based contract may be helpful. For instance, savings and/or future benefits from improved preventive health care, stable housing, or reduced recidivism are usually not available until long after the costs of delivering these services have been incurred.

"Most service providers don't have the financial wherewithal to take on all the risk of these pay-for-success contracts," says Phillips. "That's what the financial markets do all the time."

Paying for Outcomes and Impacts

When payment is contingent on performance, all stakeholders develop a laser-like focus on the outcomes and impacts. Defining expected targeted outcomes—performance metrics to be attained—and anticipated impacts—changes in behaviors or circumstances to be realized—entails both cooperation and innovation among government, private investors, intermediary agencies, and evaluators.

Considerations include: How long should investors wait for outcomes and impacts? What is a fair interest rate? What are reasonable outcomes and impacts to expect from service providers? How will we know if those have been achieved?

"There is room for negotiation in there," says Phillips. "The expected returns on these deals for the senior investor have been mid-to-high single digits. The terms of these deals and the appetite for typical investors is probably five to eight years."

To offset the full burden of risk, many impact investors seek a level of "de-risking" or credit enhancement in each investment. Typical of other investments, these credit enhancements may include a partial principal guarantee from a philanthropic organization or a secondary investor with more risk appetite.

Theory Meets Practice: Social Impact Bonds in Salt Lake City

Studies and experience have shown that high-quality early childhood education programs lead to improved academic and emotional development, and that these benefits last. Giving a child a solid foundation early in life also saves money in later remedial, special education, and other costs.

Context: A Preschool Program in the Right Place at the Right Time

In the early 2000s, the Granite School District in Salt Lake City sought to expand its Utah High Quality Preschool Program. A request for federal funds for this purpose was approved and the ensuing program enhancements resulted in strong outcomes for all children, but especially for the low-income children who attended the program.

"We followed those kids when they were in third and fourth grade, and found that the achievement gap between these low-income kids and their more affluent peers was effectively closed," says Chris Ellis.

The school district brought to the partnership table, therefore, a program with a solid track record of documented success over a period of years and a desire to expand its reach by recruiting more children. The United Way brought a consortium of business, government, evaluation, and nonprofit leaders with a history of working together for the Salt Lake community. Goldman Sachs and J. B. Pritzker brought money and a willingness to risk it on investments in children.

Enter Social Impact Bonds

Discussions with Goldman Sachs began in 2010, which is the first year social impact bonds appeared on the policy and financing horizon in the United States. According to Phillips, "The first thing we asked was 'How do we know that you are going to achieve the impacts you need to achieve that will allow the contract to repay us?' Achieving these goals drives both the social impact and repayment of the loan."

The team on the ground in Salt Lake City had answers. They were able to produce several years of outcome data from evaluations of the preschool program, describe and share its curriculum, and offer detailed projections about expansion plans. Importantly, the team also demonstrated a shared vision and cohesive management and leadership capacity.

By June 2013, officials at United Way of Salt Lake had negotiated \$7 million in private-sector loans, to be repaid with interest from savings realized by reduced costs of special education services attributed to the Utah High Quality Preschool Program.

With the start of the 2013-14 school year, Utah's "Pay-for-Success" program became the country's first social impact bond for early childhood services. It financed an expansion of the Utah High Quality Preschool Program to serve 3,500 new children recruited in five cohorts. There were no upfront costs to taxpayers.

Key actors at the outset of Pay-for-Success were:

- Government: State and county officials
- Investors: Goldman Sachs (the primary investor, \$4.6 million loan); J. B. Pritzker (secondary investor, \$2.4 million loan)
- Intermediary: United Way of Salt Lake
- Service provider: Granite School District
- Evaluator: Utah State University

Chris Ellis recalls, "We saw this as an opportunity to further our collective impact work. We played the backbone role, helping facilitate and align partnerships at schools, at system levels and with other preschool providers."

In the 2013–14 school year, 595 low-income children entered the preschool program. All 595 children were screened using the Peabody Picture Vocabulary Test. Some 110 were identified through screening as likely to require special education services while in grade school.

Evaluators from Utah State University are tracking these 110 children through sixth grade to determine whether they utilize special education services, and for how long. No one from the preschool program, the United Way, or Goldman Sachs knows which children are being tracked.

Following the Money

By 2015, early findings from the evaluator suggested that the preschool program and the Pay-for-Success financing strategy were working. Of the 110 children identified as likely to need special education in grade school, only one went on to use those services in kindergarten.

With that milestone, investors were due their first repayment, the first such payment for a social impact bond in the United States. Through formulas used to determine the cost of special education services avoided, savings were determined to be $281,550 in the first year, or $2,607 per child[1] for children served by the program during its first year. These savings generated a payment to investors of about $267,000.[2] If performance continues as expected, estimated savings to the State of Utah for the first cohort of children would exceed $1 million through 12th grade.[3]

Under the Pay-for-Success contract with the State of Utah, investors receive 95 percent of state savings in special education costs until the investments are repaid with interest.[4] The base interest rate on the loan is 5 percent.[5] Thereafter, Goldman Sachs and Pritzker will receive "success fees" until the children complete sixth grade or until the return is 7.25 percent. Savings after that time will accrue to the state and school districts.[6] Chris Ellis recalled, "Once the rest of the partnerships were established, all we needed was an agency to repay the loan investment based on the success of the program for cohorts 2–5. We figured that the government made the most sense and securing their participation would be fairly straightforward. This, however, proved to be a complex process."

Initial efforts to pass state legislation to repay investors did not succeed. To keep Pay-for-Success on track, therefore, the board of directors of the United Way of Salt Lake set aside $1 million and Salt Lake County set aside $350,000 to repay investors for the first cohort of children.

In the next year, with passage of HB96: the Utah School Readiness Initiative in March 2014, the Utah State Legislature allocated funds for repayment of investor loans for the remaining four cohorts of children. The Act also allows a newly established School Readiness Board to enter into Pay-for-Success contracts with private investors on behalf of the state, and authorizes other expansions of early childhood education throughout the state. "We were expanding access to proven quality programs and through the legislation were able to change the conversation in Utah around early childhood education," said Ellis.

[1] *www.ssir.org/articles/entry/pay_for_success_is_working_in_utah*

[2] *www.sltrib.com/home/3032598-155/preschool-paying-off-for-goldman-sachs*

[3] *www.goldmansachs.com/what-we-do/investing-and-lending/impact-investing/case-studies/sib-slc-fact-sheet.pdf*

[4] *www.sltrib.com/home/3032598-155/preschool-paying-off-for-goldman-sachs*

[5] *www.hceconomics.uchicago.edu/sites/default/files/file_uploads/SIB-RBFFact_SheetUtahVersion.pdf*

[6] *www.hceconomics.uchicago.edu/sites/default/files/file_uploads/SIB-RBFFact_SheetUtahVersion.pdf*

Reflections

> *I think there is a little myopia about raising private capital to help government do the things it doesn't do, and one of the things I get asked is, "Why doesn't government just do these things?"*—John Roman

The experience in Utah is encouraging, but social impact bonds are new and many questions remain unresolved.[7] Utah's experience illuminates these questions and raises other issues that warrant further exploration.

Why Has Uptake Been Slow?

As of March 2016, Goldman Sachs had executed four social impact bond investments. Executing the contract in Utah, which was especially well positioned to use this approach, took three years.

What is a reasonable time line for developing a social impact bond or outcomes-based financing? Will experience lead to shorter time lines? What accounts for a slow uptake in interest?

Government agencies and investment firms are cautious about doing business in such a fundamentally different way. Some point to government as a major source of bottleneck and others point to the investment firms.

John Roman holds that there are high-net-worth individuals, venture capitalists, and private investment firms "who are looking for investments like this and want to invest in good works." He asks why government agencies in particular seem reticent to get involved in these transactions. "We are talking about 100 percent reduction in their risk, and the government says 'No, thank you.'"

There are reasons for government hesitancy. City and county officials, those most likely to pursue social impact bonds, are not necessarily familiar with the language and intricacies of private investment. In addition, public entities responsible for repaying the loans must feel confident that the programs they propose are well developed and are backed by enough of the "right kind" of evidence.

Higher levels of government impose multiple regulatory and reporting requirements on city and county government agencies, and those requirements have to be considered. "The good news is there is a lot of work going on

[7] For example, some have challenged use of the Peabody Picture Vocabulary test as an appropriate method of screening children for special education needs. See *www.nytimes.com/2015/11/04/business/dealbook/did-goldman-make-the-grade.html?_r=0* for this discussion and *www.nytimes.com/2015/11/14/business/dealbook/why-social-impact-bonds-still-have-promise.html.*

in Washington to get the federal government to okay these types of structures," says Phillips.

Louise Cohen, MPH, CEO of the Primary Care Development Corporation and moderator of the panel, asked why investors weren't flocking to opportunities that purport to offer "high-digit" return on investments in proven social programs. In response, Andrea Phillips explained that "the deals are hard to do because they ask government and other stakeholders to do business in a new way. But with 60 deals done globally, we believe we are on the cusp of seeing more standardization and simplification. I'm cautiously optimistic that these efficiencies will lead to real growth of this nascent market."

How Much Evidence Is Enough Evidence?

Investors seeking reassurance that they will be repaid understandably favor programs with long track records of outcomes and impacts. But how much evidence is enough? How often do proven programs have to re-prove their effectiveness? Are investors open to financing less mature programs that show promise? Those questions have not been answered.

Cohen argues that government agencies use evidence-based interventions that yield strong outcomes "all the time." The bigger challenge, she maintains, is scaling an innovative approach that evidence has shown to work in a "boutique" setting. How seriously would private investors consider investing in one of these programs without needing a new randomized controlled trial?

Phillips suggests an alternative to asking investors to support these younger but promising interventions. "I do think that is a great role for philanthropy, as an angel investor in the early stages of innovation."

At the other end of the evidence spectrum, some programs—Nurse-Family Partnership for one—have decades of solid evidence behind them demonstrating their long-term impacts and cost savings. Do they need yet more evidence to establish their value? Perhaps the evaluation should examine the financing mechanism rather than the intervention.

"From where we sit as investors, we are looking for a contract that clearly defines the outcomes we expect and how we will know if we got there," says Phillips. "Investors will look at prior evaluations and historical data to assess the likelihood of achieving the agreed-upon outcomes."

There is not a simple or single way to address these challenges. Decisions about whether to propose or finance a program for a social impact bond require shared confidence that at some future date there will be consensus about whether the intervention unfolded as it was supposed to and whether it achieved the intended outcomes.

Arriving at that shared confidence may entail negotiating an acceptable middle ground. The city of Chicago, for example, aimed to use its social impact bond to increase high school graduation rates, but investors wanted a more immediate repayment trigger. The city, the school district, and the investors ultimately agreed on three benchmarks—kindergarten readiness, third-grade reading, and decreased rates of special education usage—which, taken together, would be strong enough indicators of future high school graduation.

In the case of Utah's preschool program, it was not hard for all partners to agree on the big goal—keeping young children in Utah on track at school. The question then became how to measure progress to reach consensus on whether that happened.

How Big Is Big Enough? What Is Adequate Scale?

What does it mean to go to scale? Salt Lake City's Pay-for-Success, for example, increased participation in quality preschool programs, eliminated the 400-child waiting list for early childhood services in Salt Lake, and allowed new children to be recruited. It also expanded from the Granite School District to one additional district, two private providers, a charter school, and one nonprofit organization. Is that a reasonable expectation for one social impact bond? Does this expansion "count" as scale?

Roman believes that, with good data, there are ways to answer those questions. He characterizes social impact bonds as "forcing mechanisms" that promote both scaling and quality improvement. Within evaluations of stable programs trying to expand their reach, "there also tends to be a component that examines, 'Are we implementing with fidelity?' and 'Are there subgroups for whom this works better?'."

Ellis took a broad perspective. He noted that the social impact bond had prompted the first expansion of early education services, which in turn prompted state legislation in Utah that added yet more capacity and provided a stable source of funding over time. Importantly, this experience also engendered significant changes in how stakeholders talk about early childhood education.

"We have seen that new grants are improving quality around the state. I don't know if social impact bonds alone are going to be the strategy that allows us to meet the commitment we have to all children, but the bonds have been able to catalyze more conversations about early childhood education," he said. "The providers are not talking only about programmatic-level outcomes. They are also talking about how what they are doing aligns with the broader atmosphere around early childhood education."

Can the System Be Gamed?

Is there potential for manipulating an intervention to skew results? Are there protections against paying or otherwise coercing people to engage in a desired behavior, thereby falsely suggesting that the social intervention reached its intended outcomes?

Roman notes that, while "there is a lot of pressure for me to put my finger on the dial toward a particular outcome," the partnership structure of social impact bonds reduces the likelihood that will happen. The participation of multiple partners in intensive contract negotiations surfaces and clarifies the incentives that drive each partner to participate. This means the intervention takes on a collective nature. As Roman puts it, "This is the only place in governance where there is a collective understanding of other people's incentives, and if we want to scale the use of evidence, having that collective among all the partners is absolutely critical."

What Attributes of a Community Suggest Success?

Phillips noted several characteristics investors value in deciding whether to invest in community financing: a group of people capable of implementing the project, a system with capacity to scale, a management team with depth, and sound systems of performance management and professional development. "This is similar to what we consider with any type of investment. We are not trying to micromanage what is happening on the ground. We ask the service providers to explain to us what the core principles of the program are and how they have delivered the outcomes in the past. Then, they can have nimbleness around that."

Investors also look for reassurance as to the creditworthiness of the proposed contract. Two, three, or even five years down the road, will the government in fact repay the loan? The issue of future appropriation is not unique to social impact bonds but is a challenge faced in many government contracts. Particularly in this nascent phase of the social impact bond market, this is a risk that investors acknowledge and for which they have developed strategies such as legislative action, contractual language, and more.

Social impact bonds in the United States are little more than four years old. Only a handful of contracts have been executed, and, although it is too early to be certain whether this approach to growing and improving social services will endure, early results show strong signs of success. Within the context of building a Culture of Health, a strategy in which public, nonprofit, and private-sector partners collaborate and put their financial and programmatic assets on the table deserves a full and fair test.