INVESTING FOR SUCCESS

SOCIAL IMPACT BONDS AND THE FUTURE OF PUBLIC SERVICES

JENESA JERAM
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THE NEW ZEALAND INITIATIVE

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2015

The New Zealand Initiative is an independent public policy think tank supported by chief executives of major New Zealand businesses. We believe in evidence-based policy and are committed to developing policies that work for all New Zealanders.

Our mission is to help build a better, stronger New Zealand. We are taking the initiative to promote a prosperous, free and fair society with a competitive, open and dynamic economy. We develop and contribute bold ideas that will have a profound, positive, long-term impact.

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Views expressed and all errors or omissions remain the sole responsibility of the authors.

FOREWORD

The New Zealand Government has pleasingly shown a willingness to explore new initiatives for achieving better social outcomes from its social policies. The challenge is not simply to provide more funding but rather to concentrate on how to achieve successful outcomes, including developing improved ways of working with private sector social service providers.

One technique now being utilised overseas involves governments working with private sector service providers and investors through the use of Social Impact Bonds (SIBs) not only to help fund social services but also to align the incentives of all the parties to achieve better, well defined outcomes.

If this can be done, then several desirable objectives could be achieved: a better use of the taxpayers' money; the provision of private sector funding to complement taxpayer funding; returns to investors but only if successful outcomes were achieved; and, of most importance, superior social outcomes for those in need.

Jenesa Jeram and Bryce Wilkinson of The New Zealand Initiative have done an excellent job in setting out how these new instruments could potentially be used in New Zealand.

They have not shirked the challenges in setting up SIBs, which can be complex instruments, and they have been cautious in recognising that SIBs, although now used in a number of countries, are still at an early stage of development. On the other hand, SIBs offer a potentially rewarding way of improving social policy outcomes which in itself has been a long term challenge for most governments around the world. Trialling them is an experiment well worth undertaking.

SIBs involve a different approach to philanthropy and would require a new form of cooperation between the government, private sector social agencies and the philanthropic sector.

This paper sets out comprehensively and with admirable clarity how this could happen. It is an exciting possibility and The NZ Initiative is to be applauded for pursuing such innovative ideas which could in time make a significant contribution to improved social policy outcomes and a better New Zealand.

Sir Roderick Deane

Chairman
IHC Foundation

EXECUTIVE SUMMARY

For too long, successive governments in New Zealand have been extoled for simply giving things a go (spending money) in social services rather than actually achieving results. As Finance Minister Bill English has said, "Too often Government is flying blind. You let us get away with getting up and saying 'we spent $20 million on a problem that shows we care'.'[1] Or worse, governments are castigated for experimenting with new programmes, despite evidence the current system is failing.

This report explains the concept of Social Impact Bonds (SIBs), a new yet unproven tool, for which many have high hopes for securing better social outcomes. The report draws some lessons for New Zealand from overseas experiences to date with SIBs. It also makes some recommendations on how to successfully apply the model in New Zealand.

Chapter 1 puts SIBs in the context of the current government's many new initiatives aimed at getting better social outcomes from government spending. One feature is a greater emphasis on funding achieved outcomes rather than merely funding outputs or inputs. SIBs are one of many tools in the government's toolkit.

As explained in Chapter 2, SIBs are a new way of financing and delivering some social services in New Zealand. They almost invariably involve private service providers and investors partnering with government to deliver social services – and may potentially produce better outcomes for both taxpayers and recipients of social services. SIBs typically involve:

- contracts allowing private investors, private service providers, and often an intermediary partnering together to fund and deliver certain agreed-upon social outcomes;
- a government contract, with financing arrangements that are fully or partly linked to successful performance-related outcomes;
- returns to investors contingent in whole or in part on performance-related payments; and
- an independent assessor who verifies and evaluates the performance of contracting parties to reduce the risk of disputes over performance payment triggers.

SIBs are not appropriate for all forms of social service provision. They require a government or a non-government agency prepared to commit to fund the achievement of well-defined and objectively measurable social outcomes; at least one service provider capable of achieving the target outcomes at an acceptable cost; and at least one external investor prepared to fund the costs of providing the service and accept the risk that the targets may not be achieved.

Yet, where applicable, SIBs can be attractive for government, investors and service providers alike:

- Government benefits by transferring a variable degree of financial risk to the private sector. SIBs demonstrate which programmes work or don't work, so that effective models can potentially be brought to scale.
- As an alternative to making charitable donations, SIBs allow investors to more directly improve social outcomes for favoured causes, and support advances in measuring successful models and building an evidence base, while earning a financial return for their involvement.
- Finally, service providers can hope to gain from enhanced delivery flexibility and broadened access to investor expertise and capital.

Yet, SIB structures can be complex. Chapter 2 discusses at some length the challenges they pose to those seeking to develop the market and for those participating in any particular SIB, be it as an intermediary, investor, service provider, or procurement agency.

1 Bill English, "Address to New Zealand Data Futures Forum," Cited in Bernard Hickey, "English Eyes Major Data Centric Reforms to Budget Reporting after the Election," Interest.co.nz (9 June 2014).

Chapter 2 also explains that the Ministry of Health is currently leading a pilot for SIBs (referred to as 'Social Bonds' by the Ministry and other government departments) to test their potential in New Zealand.

Chapter 3 summarises overseas developments to date with SIBs. It looks in particular at the early SIBs in the United Kingdom, Australia and the United States.

The first SIB was introduced in 2010 in the United Kingdom. SIBs are being considered on such a broad front internationally that it is difficult to get a definitive up-to-date count of the number in existence. According to Social Finance UK, 25 SIBs had been commissioned, in total, in seven different countries by August 2014.[2] A 2015 report by the Policy Innovation Research Unit, funded by the UK Department of Health, identified operational SIBs in Australia, Belgium, Canada, Germany, and the United States. It also cited a 2014 assessment that more than 100 SIBs were in development.[3]

Chapter 3 makes it clear that the success in practice of SIBs as a tool for achieving better social outcomes in a cost-effective manner has yet to be established. SIBs have not been around for long enough to assess whether the results will justify the high expectations of their promoters. But enough has been learnt about their complexities to inform those who are following the leading countries. To date, central or local government leadership has been essential to developing SIBs.

Chapter 4 draws lessons from the case studies for New Zealand and proposes a number of measures for enhancing the likelihood of success for SIBs in New Zealand. But first it notes that converting potential gains into real gains is a challenge because:

- New Zealand has a relatively immature social finance and investment market compared to countries like the United Kingdom. Yet the UK government has felt the need to introduce many policy initiatives to promote the development of a SIB market.
- Initiating SIBs is a complex and time-consuming task, potentially deterring would-be participants and demanding well-designed SIB contracts.
- Political risks such as a change of government, a change of policy, and overly bureaucratic processes affect a SIB, and can deter service providers and investors.

Lessons we draw for the development of the SIB market in New Zealand include the importance of:

- government leadership and promotion to initiate and develop the market for SIBs involving government procurement;
- preventing political or bureaucratic risk aversion (the fear that a pilot SIB might fail or cause embarrassment) from unduly stifling delivery freedom;
- avoiding monitoring regimes that impose burdens on service providers that unduly impair their capacity to achieve performance targets; and
- ensuring that government laws and regulations do not unnecessarily inhibit the development of private initiatives to develop SIBs independently of government.

Our proposals for enhancing the likelihood of success for SIBs in New Zealand comprise:

- establishing a special Treasury unit to approve SIB programmes, contracts and funding;
- using crowdfunding to finance SIBs;
- having philanthropists replace the role of government as commissioner and financer of SIBs; and

2 Social Finance UK, "The Global Social Impact Bond Market," *Snapshot* (London: Social Finance UK, August 2014).

3 Stefanie Tan, Alec Fraser, Chris Giacomantonio, Kristy Kruithof, Megan Sim, Mylene Lagarde, Emma Disley, Jennifer Rubin and Nicholas Mays, "An Evaluation of Social Impact Bonds in Health and Social Care Interim Report," PIRU Publication 2015–12 (London: Policy Innovation Research Unit, 2015).

- using the iPredict prediction market to track the political risks associated with SIBs, and incorporate those risks into contractual arrangements.

Chapter 5 presents our concluding comments.

The SIB pilot in New Zealand is timely. The Key Government has recognised that simply spending money on services, with inadequate accountability for measurable outcomes, is a poor use of taxpayers' money while doing great disservice to those receiving social services. At the same time, New Zealand's non-government social enterprise and social entrepreneurship landscape is thinking innovatively about how to improve social outcomes based on new technologies, internet platforms, and international trends and domestic conditions.

These developments enhance the potential for SIBs to produce better social outcomes for New Zealanders. It is pleasing to see New Zealand making a promising start in this direction. But the number of activities that lend themselves to SIBs is limited, and the challenges to be overcome along the way in developing and growing the market are real. It is very important for the early development of this market that government leadership remains strong and that any pilot SIBs encourage the parties involved and others to seek to be involved in subsequent SIBs.

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ONE
INTRODUCTION

Social Impact Bonds (SIBs) are an innovative way of harnessing private sector social service delivery to produce better, measurable social outcomes. They are an alternative to the current model of government, charities and NGOs providing social services. Also known as 'Social Bonds,' 'Social Benefit Bonds,' 'Payment-by-Results,' and 'Payment-for-Success,' SIBs were pioneered in the United Kingdom in 2010, and have attracted much international interest, including in New Zealand.

Successive governments in New Zealand have spent billions of dollars annually to improve social outcomes in recent decades, but troubling social issues continue to proliferate. The Key Government is focusing intensively on improving the social returns from spending on social services. It is driving state agencies to: understand better the drivers of good and bad outcomes, get better at measuring the returns from social spending, and get smarter at procuring social services.[4]

This policy change is based on the Government's belief that new and innovative ways of combining expertise and knowledge in the private, social and public sectors could help produce better social outcomes through better value for money.

In his address to the Institute of Public Administration New Zealand this year, Minister of Finance Bill English emphasised the need for outcomes-based measurements and social investment. He also signposted a shift from regarding the users of public services as clients to customers "who might have an opinion about our service, or might want a choice, or might have aspirations of their own that don't suit us."[5] This requires a more integrated 'cross-government' approach by government agencies and a greater role for private provision of social services.

The Key Government has already introduced the following policy initiatives:

- Better Public Services includes specific outcome targets for infant immunisation, early childhood education, reductions in serious assaults on children, better education achievement, and reduced crime rates, including re-offending rates;
- Whānau Ora integrates a range of social services, including health, education and social services, to improve outcomes for families;
- Children's Teams address vulnerable children by integrating the expertise of professionals, practitioners and NGOs from relevant sectors;
- Social Sector Trials aim to reduce truancy, alcohol and drug abuse, youth offending, and increase youth participation in education, training and employment (11 of the 16 trials are being led by NGOs);
- Social Housing Reform is a cross-agency initiative aimed at partnering with community housing providers to improve outcomes and grow the community housing sector; and
- Pilot SIB programme.

Lead government agencies include:

- The Ministry of Business, Innovation and Employment, which is streamlining NGO contracts;

4 Refer, for example, to the New Zealand Government and Productivity Commission, "Terms of Reference for an Inquiry into Enhancing Productivity and Value in Public Services" (Wellington: June 2014).

5 Bill English, "Speech to the Institute of Public Administration New Zealand," beehive.govt.nz (Wellington: 19 February 2015).

- The Ministry of Social Development, which offers lessons on contracting and measuring outcomes as part of its Social Sector Trials and Investing for Outcomes programmes;
- The Treasury, which is working on procuring Public Private Partnerships and using non-government finance to transfer risk, including social outcome risk in the case of Wiri prison; and
- The Department of Internal Affairs, which is working on improving the legislative and regulatory environment for social enterprises.[6]

The timing of a SIB initiative could not be better for New Zealand. In addition to the above government initiatives to restructure the ways the state funds and delivers social services, private social enterprise and social entrepreneurship are also on the rise in New Zealand, creating a positive culture and community for anyone with good ideas to improve social outcomes. SIBs increase the scope for individuals and groups to bring about real change in their community while holding service providers accountable for results. SIBs also open up avenues for a hitherto untapped source of social activists – non-government groups or individuals seeking to improve social outcomes but who are also investors hoping to receive their principal contribution back, plus a return. Individual philanthropic motivations can also harness investor interests and skills through electronic platforms to enhance delivery performance and accountability. This is a real 21st century innovation.

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6 KPMG, "Social Bonds: Business Case for the Ministry of Health" (2013).

TWO
WHAT ARE SOCIAL IMPACT BONDS?

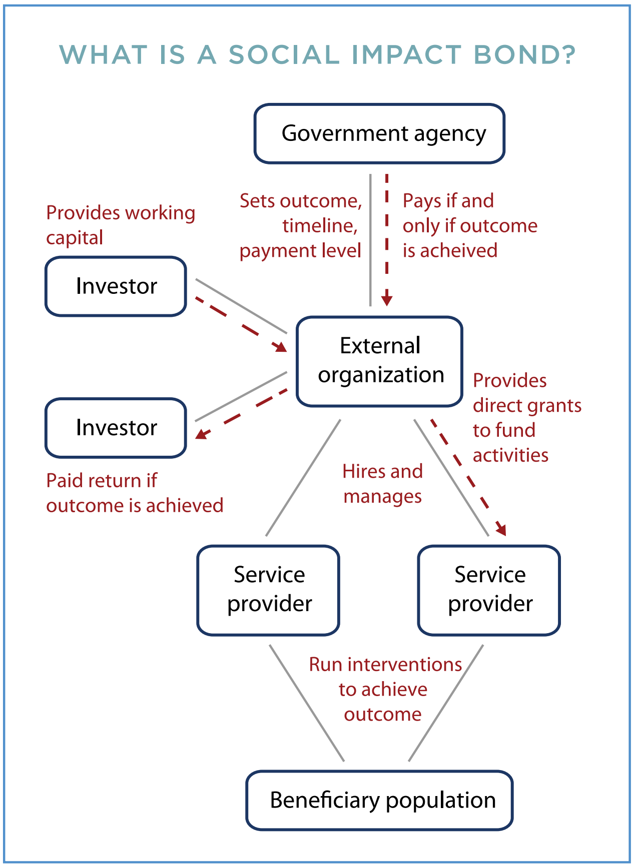
In essence, SIBs involve multiple contracts allowing private investors and NGOs to partner together to fund and deliver services to achieve specific social outcomes. A critical feature is that a separate party (almost invariably the government to date) contracts to pay for achieving pre-agreed outcomes. The contingent nature of such payments creates real performance incentives for providers. To reduce the potential for disputes (on either side), an independent agency evaluates the performance of the contracting parties.

A number of parties are involved in forming a SIB:

- government departments (and/or private parties) commission contracts and contingently finance successful outcomes;
- service providers deliver the social service;
- investors provide the upfront capital to fund the delivery of services;
- intermediaries assist with raising funding and driving service performance; and
- independent assessors review and verify the results of the contracting parties to determine whether the agreed outcomes have been achieved and reduce the potential for disputes.

Figure 1 illustrates just one possible SIB structure and the relationships between various parties.

Figure 1: Typical SIB structure



Source: Kristina Costa, Sonal Shah, Sam Ungar and the Social Impact Bonds Working Group, "Frequently Asked Questions: Social Impact Bonds" (Washington, DC: Center for American Progress, 5 December 2012).

Many variations of this basic structure exist, and continue to be devised as the SIB market develops and the model extends to new jurisdictions and social issues. Internationally, different jurisdictions have used different commissioning frameworks, and different types of investors have changed the structure of SIBs. The degree of investor risk can also differ by using a range of mechanisms such as guarantees, loss sharing between investors and grant donors, or staged payments linked to interim outcomes. The procurement process also differs internationally, with the government (which commissions a majority of SIBs), the intermediary, or the service provider procuring for outcomes.

However, the following features are common to all SIBs:

- Payment is contingent on results achieved in part or whole;
- Social service delivery targets a clearly defined population;
- Outcomes must be measurable and assessed by an independent authority;
- Investors are from the private sector. Risk is therefore shifted from the government/taxpayers to private investors, although the degree of risk transfer is flexible; and
- Successful outcomes ensure investors receive a financial repayment. This can involve principal investment returned; principal investment plus a modest return; or principal investment plus a superior return. Financial repayments are often linked to the degree of risk assumed by investors at the contracting stage.

Just as the structure of SIBs may vary, the commissioning and procurement processes do too. While most SIBs are commissioned (the organisation purchasing the social service) by the government, they can also be commissioned by service providers, intermediaries or private individuals. The commissioner may procure for a SIB in any area, or for a specific social outcome. Box 1 lists the steps in New Zealand's SIB pilot (not all procurement processes will follow these steps).

BOX 1: MINISTRY OF HEALTH PROCUREMENT PROCESS

AS OF MARCH 2015

Phase 1: Registration of Interest (ROI) Service Outcome & Providers (Completed)

ROI to assess and recommend shortlist of Service Outcomes and associated Providers.

Phase 2: ROI for Intermediary (Completed)

ROI to assess and recommend shortlist of Intermediaries.

Phase 3: Solution Establishment (Current Phase)

Market introduction between shortlisted intermediaries and service providers. Structured approach to establishing the principles, fundamentals and scope of SB Pilot solution.

Phase 4: Closed RFP

Shortlisted intermediaries invited to respond to Request for Proposal (RFP). RFP will ask for proposed service outcome, service delivery model and SB Pilot solution.

Phase 5: Contract Negotiation

Government will require a contract with the Intermediary regarding performance and payment.

Phase 6: Pilot Establishment

Government will work with all parties where required during the implementation phase.

Source: Ministry of Health, "Social Bonds – New Zealand Pilot," Website (2014).

WHY ARE THEY CALLED SOCIAL IMPACT BONDS?

Different jurisdictions use different terminology for SIBs. The term 'Social Impact Bond' originated in the United Kingdom and invokes the involvement of investors to achieve a social impact. In the United States, the term 'Payment-for-Success' is more prevalent and focuses on the contingent payment aspect rather than the outside investor aspect. The term 'Social Benefit Bond' is widely used in Australia, while the Ministry of Health in New Zealand uses the term 'Social Bond'.

However, Social Impact Bond is becoming the most recognised description internationally and is the term used throughout this report.

WHAT AREAS ARE THE FOCUS OF SIBS?

Internationally, SIB programmes tend to focus on:

- young ex-offenders;
- families with children in care;
- early childhood education;
- young people not in training, education or employment (NEET);
- employment for ex-offenders;
- high-risk young men; and
- single mothers.

SIBs are not appropriate for all forms of social service provision. They require participants prepared to commit to funding the achievement of well-defined and objectively measurable social outcomes, at least one service provider capable of achieving the target outcomes at an acceptable cost, and at least one external investor prepared to fund the costs of providing the service and accept the risk that the targets may not be achieved. McKinsey & Company argues that the interventions best suited to SIBs are those that focus on prevention, have a multi-year track record, can deliver statistically significant results, meet the needs of a sizable population, are replicable and scalable, and can deliver taxpayer benefits within a reasonable time.[7]

The easiest programmes for governments to approve would be those that produce net fiscal savings for the state. It becomes more complex when savings can only be captured if the impact is of significant scale, when savings are dispersed across several expenditure lines, or when savings are at the community rather than government level.[8] Net fiscal savings will, however, need to be balanced with the overall effectiveness of programmes, where a SIB programme may replace an existing less-effective social service.

The literature to date also suggests that SIBs might not be appropriate for the following activities:

- research and exploration, where outcomes may be particularly difficult to observe and measure;
- status quo programmes, where it is difficult to attribute outcomes to individual programmes;
- new and unproven services, where it may be difficult to obtain investor 'buy in'; and
- politically controversial programmes, where the risks of political termination may be high.

SIBs are thus best considered as one tool in the social sector toolbox.

Figure 2 provides a 'decision tree' guide to the general circumstances lending themselves to the consideration of SIBs as envisaged in this report. Government agencies are generally presumed to commission SIBs; however, Figure 2 allows for private parties to take on this role.

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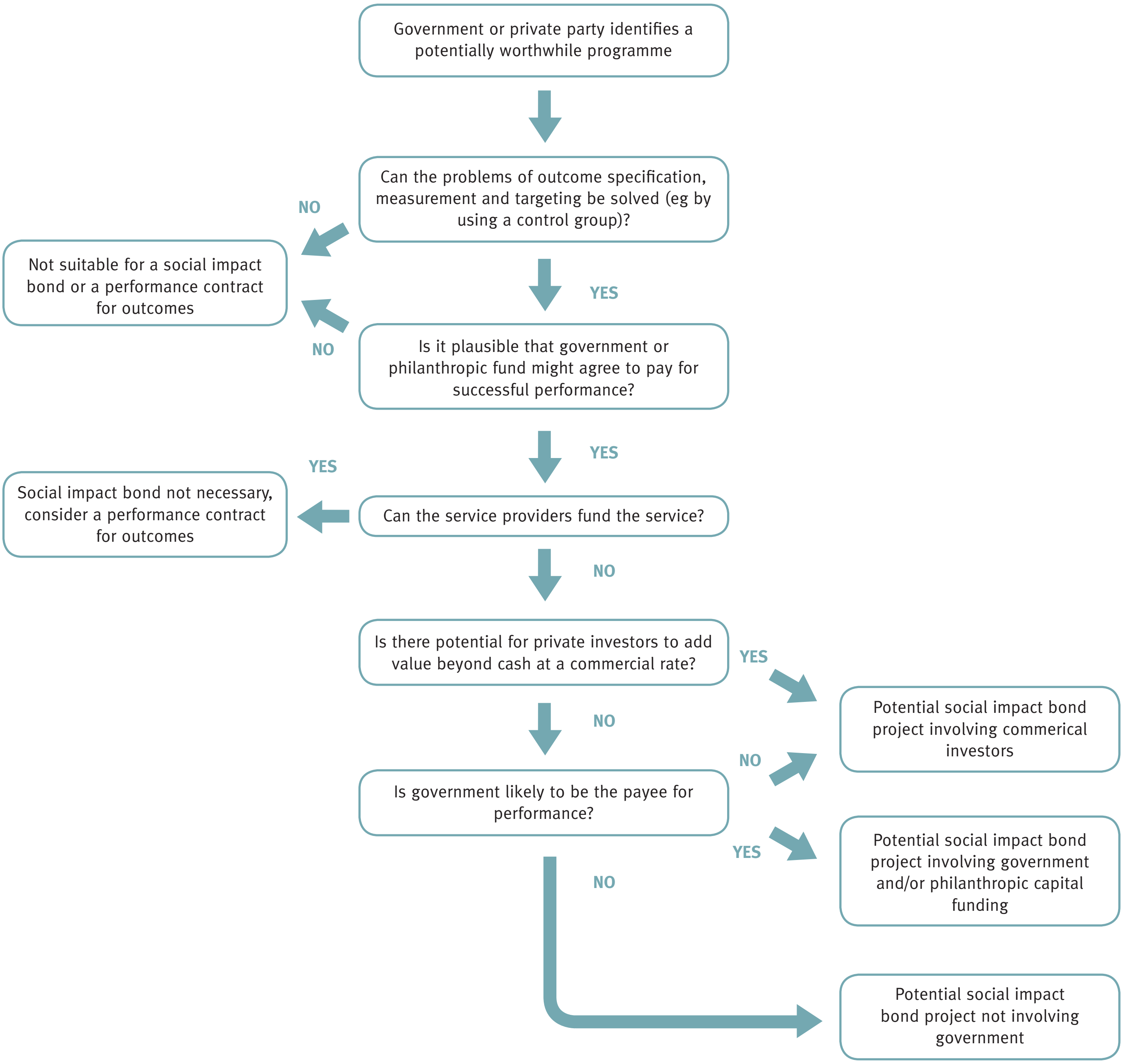
7 McKinsey & Company, "From Potential to Action: Bringing Social Impact Bonds to the U.S." Website (May 2012).

8 Elyse Sainty (Senior Advisor, Impact Investing), Social Ventures Australia, email correspondence (4 March 2015).

Figure 2: Indicative decision tree for SIBs



WHAT ARE THE POTENTIAL ADVANTAGES OF SIBS?

Better outcomes are more likely to be achieved

The outcomes focus of SIBs rewards results rather than good intentions.[9]

Under SIBs, the government contracts with the private sector and investors to provide social services, but payment is contingent on achieving pre-agreed social outcomes. The focus on outcomes rather than on social service inputs or outputs, and the contingent nature of payments, creates real performance incentives for service providers and investors, and shifts financial risk to the private sector. Potentially, taxpayers pay for successful outcomes, but not otherwise.

This contingent payment feature distinguishes SIBs, and the broader category of performance-related contracts, from conventional government funding for inputs (administration, staff and resources) or outputs (a particular service) regardless of outcomes (whether the service achieves what it says it will achieve). For instance, the government funds the delivery of public education, but the funding is not often dependent on the educational outcomes achieved (for instance, increasing the numeracy of a cohort by a certain percentage). A similarly less-focused option is where the government funds the private provision of outputs independently of outcomes.

SIBs aim to improve social outcomes by tapping into local and globally dispersed knowledge and expertise (compared to the inevitably incomplete and fragmentary nature of public servants' knowledge of social problems). Indeed, the lack of public service information concerning the costs of achieving given outcomes has been mentioned to the researchers as an impediment to the development of SIBs in New Zealand from both measurement and value-for-money perspectives.

The power of competition for harnessing widely spread information is hard to exaggerate. Competition to secure SIB contracts opens the door to all those who want to enter the social services sector, while inducing them to innovate, manage risks and control costs.

Taxpayers are less at risk of funding ineffectual interventions

Conventionally, taxpayers fund government social spending regardless of results. With SIBs, taxpayers only pay if programmes achieve better outcomes.

Potential for fiscal savings

SIBs that deliver better social outcomes may also produce longer-term fiscal savings, for example, through reduced future spending on prisons, the police, welfare workers, remedial education, and welfare benefits. Indeed, many SIBs internationally focus on prevention, such as reduced rates of recidivism, detention or family break-up.

While such savings may potentially exceed the original fiscal costs of funding SIBs, evidence for this to date has been discouraging (see Chapter 3). It is more likely that at least in the short term, the main benefit from SIBs will come from achieving better social outcomes, rather than fiscal savings. The transaction costs of SIBs could be high relative to the amount of capital raised, particularly in the early stages of their development. McKinsey & Company considered that there was a relatively low potential for significant fiscal savings by the US government. Fiscal savings come primarily from the success of preventative programmes over remedial programmes, rather than from the service provision being cheaper overall.[10]

9 McKinsey & Company, "From Potential to Action: Bringing Social Impact Bonds to the U.S." op. cit.

10 McKinsey & Company, "From Potential to Action: Bringing Social Impact Bonds to the U.S." op. cit.

Potential for gains from scaling up successful pilot SIBs

Successful SIB delivery models may be rolled out on a larger scale, and with greater government backing. Successful providers can expand, and successful government programmes can displace less successful ones. Hopes of achieving scale may justify investing in the high initial start-up costs of a pilot. The more the SIB market develops, the greater the potential for achieving scale economies.

Greater scope for provider freedom to innovate

Innovation is difficult to achieve in the public sector where bureaucratic processes tend to be risk averse. Bureaucratic programmes can be difficult and expensive to change, even when they are known to be flawed or ineffective. As the Center for American Progress points out, many output-based contracts between the government and the private sector proscribe what outputs the government wants to buy from the service provider, and how the services are to be delivered.[11]

The potentially large freedom of contract between intermediaries and other parties permits scope for innovation and flexibility that public sector agencies might be rarely able to achieve because of political constraints and risk aversion. Toby Eccles, founder of Social Finance UK, and key leader in the development and implementation of the United Kingdom's first SIB, considers this aspect to be a major advantage of SIBs.[12] He argues that many "bits of government" are reluctant to try new approaches because of the potential embarrassment of having to pay for something that may not work.[13]

11 Kristina Costa, Sonal Shah, Sam Ungar and the Social Impact Bonds Working Group, "Frequently Asked Questions: Social Impact Bonds" (Washington, DC: Center for American Progress, 5 December 2012).

12 Toby Eccles, "Invest in Social Change," TED talk (December 2013).

13 Ibid.

Potential for harnessing investor expertise

The need for external finance also distinguishes SIB contracts from other government Payment-for-Success contracts with social service providers. But in addition to supplying funds, investors may also contribute other services and attributes such as business acumen and entrepreneurship; financial management expertise and discipline; and skills in governance and incentive alignment. They may enhance service delivery by offering new perspectives, skills and insights into what works in practice. If well-harnessed, such skills may improve a provider's outcomes focus and financial discipline.

Investors in Canadian SIBs under development are not positioning for active roles in service delivery but want to influence the performance expectations and governance of SIBs by engaging in the set-up of SIBs, the delivery model risks and dependencies, performance measurements, and delivery partnerships.[14] Adam Jagelewski, from the MaRS Centre for Impact Investing in Canada, says investors add credibility to SIBs, reduce financial risk for governments and other outcomes funders, and introduce a partner with a strong incentive for achieving outcomes.[15]

Greater focus on longer-term outcomes

Being outcomes focused, SIBs are better suited to ensuring the long-term effectiveness of policies. Most output-based contracts tend to focus on the delivery of a service here and now, rather than on its long-term effects or outcomes. Long-term outcomes that are not contracted for tend not to be measured or used as evidence of a programme's value. SIBs can address this problem as contracts often span over several years, and reward what actually works.

14 Adam Jagelewski (Associate Director), MaRS Centre for Impact Investing, email correspondence (10 February 2015).

15 Ibid.

Potentially less vulnerable to budget cuts

Because SIBs focus largely on preventative programmes and only pay for achieved results, they can reduce the vulnerability of these programmes to funding shortfalls and budget cuts compared to spending on remedial interventions. Remedial interventions provide critical services that are harder to take away, practically and politically.[16]

Potential to harness skilled intermediaries

The SIB model permits a private sector intermediary to be the nexus of the contracts linking a government or other procurer with service providers and investors. The intermediary may have much greater business, financial and project management skills than the normal social services provider, along with an ability to raise capital and investor confidence. These skills may also allow the intermediary to write more innovation-enhancing contracts with investors and providers. Such an intermediary can release a government procurer from the role of monitoring service providers intrusively. It could also be easier for a commercial intermediary to address the problems of a non-performing provider than for a government agency which is inevitably operating in a more politicised and less commercial environment.

In some countries, banking and financial advisory services, consultancies and venture capital firms such as Westpac and Goldman Sachs have taken on the role of the intermediary because of their capabilities in finance, contracting for performance, and project management.

Increased focus on measurement, cause and effect

SIBs require government agencies to think about determining, measuring and achieving outcomes, and to learn from the information generated by the SIB processes. That information should stimulate knowledge about cause and effect, and efficient contracting. It should also inform the design of non-SIB social spending programmes. All this would be to a greater degree than a conventional focus on funding outputs or inputs.

Output-based contracts do not incentivise optimal solutions to complex social issues, or necessarily reward the most effective organisations. Such contracts are less likely to inform payees about how services could be improved or adapted.[17]

Potential to harness philanthropic investor motivations

SIBs provide a way of attracting varied private risk capital and resources into improving social outcomes. The attracted capital might be philanthropic or commercial, not-for-profit or for-profit.

SIBs may particularly attract investors interested in creating a sustainable scheme of social finance. Eccles believes there is an incipient but untapped market for "socially motivated" investors:

> Investors get two opportunities: for the first time, they can invest in social change. Also, they make a reasonable return, and they also know that first investors in these kinds of things, they're going to have to believers [sic].[18]

Scotland's Living Balance SIB, discussed in Chapter 3, illustrates the potential for business investors to add value directly to the achievement of targeted outcomes by helping young people get jobs.

16 Kristina Costa, et al. and the Social Impact Bonds Working Group, "Frequently Asked Questions: Social Impact Bonds," op. cit.

17 Ibid.

18 Toby Eccles, "Invest in Social Change," TED talk (December 2013).

Elyse Sainty, Senior Advisor for Social Ventures Australia (which is involved in the Newpin SIB, see Chapter 3), says while direct investor input has been limited, indirect investor input in the form of active general discussions across the sector has helped share knowledge and understanding.[19] During the Due Diligence phase, investors have had the opportunity to talk directly with service providers and hold them to account.

A report by the Australian Centre for Social Impact also suggested that it could be advantageous to tap into different investor motivations and issue SIBs in risk tranches. Craig Parker, Executive Director, Head of Structured and Asset Finance at Westpac Institutional Bank, proposes a three-tier (low, medium and high) tranche structure of risk.[20] The high-risk tier would be marketed to benevolent institutions and related parties. A further recommendation was to keep investor documents as simple as possible while providing analysts with the detailed investment documentation.[21]

Potential to enhance portfolio diversification benefits

The returns on investments in SIBs are likely to be uncorrelated with share market returns, and such investments can help fund managers reduce portfolio risk.

WHAT ARE THE COMMON CHALLENGES OF SIBS?

While the SIB model clearly has a number of potential benefits, there are also a number of challenges associated with the model. These challenges can be either inherent in the general model, or dependent on the different parties involved.

Challenges inherent in the SIB model

SIBs are complex, involving many contracts linking many parties (see Appendix 1). Moreover, social outcomes are commonly difficult to measure, increasing the complexity of SIB contracts.

Key difficulties that must be addressed by SIBs satisfactorily for all parties include:

- achieving acceptable levels of risk and return for all parties;
- agreeing on exactly what outcomes are to be contracted for;
- agreeing on how the outcomes will be measured;
- achieving confidence in the competence and reliability of other contracting parties; and
- mitigating the risk of a change of government and policy.[22]

One of the greatest challenges to SIBs is common to all outcomes-based contracts: reliable measurement. The contracting parties must all agree on what to measure, when to measure, whom to measure, what are the counterfactuals, and how much 'successful' outcomes are worth to the government in monetary terms. These measurement issues arise because the economic model of SIBs must be worthwhile for all parties.

Another common criticism of SIBs arises from their relative complexity and the difficulties in establishing a programme in a new jurisdiction. Because of the many players involved, SIBs are a resource-intensive venture.

A robust performance measurement framework is critical, as outcomes need to be measured in a credible way to justify performance payments from government.[23] It is also possible, if not common, for a social programme to be let down by failings in

19 Elyse Sainty (Senior Advisor, Impact Investing), Social Ventures Australia, op. cit.

20 Centre for Social Impact, "An Australian Snapshot: Social Impact Bonds" (Sydney: 2012), p. 9.

21 Ibid.

22 Kristina Costa, et al. and the Social Impact Bonds Working Group, "Frequently Asked Questions: Social Impact Bonds," op. cit.

23 KPMG, "Investing for Social Success Phase One: Feasibility Study and Concept Design" (2012).

another part of the support system that the target population needs.[24] Likewise, it may be difficult to attribute outcomes to the successful provision of service, rather than other external factors. A control group may address this problem by indicating the outcomes that would have occurred without the service.

Challenges for government agencies

Government agencies may find it difficult to advise their minister on how much government should pay for improved outcomes. They may experience a conflict between their own roles as a service provider and funder of private provision. Being politically risk averse, governments might find it difficult to take a 'hands-off' approach to SIB services that fosters innovation.

It is a challenge to ensure the target population does not trigger payments based on cherry picking or game playing. Because of the monetary incentives involved with SIBs, there is a risk of service providers finding ways to achieve their target that tick the box but miss the point.[25] Cherry picking occurs when the easiest members of the target population are chosen for a programme, even though these members represent the exception, not the general norm of the problem. Gaming occurs where service providers meet the strict letter of the contract but not the spirit, often at the expense of the target population.[26]

There are also challenges for government agencies in harnessing cross-agency information and responding promptly and accurately to private sector proposals and requests.

Jagelewski says long government procurement processes are sending mixed signals to investors. Investors have flagged government partnership as a counterparty risk, and that without transparent processes and/or timely decisions and action, Canadian investors have grown weary of government commitment.[27]

SIBs and other Payment-for-Success contracts can help improve outcomes across a range of social issues. But an exclusive focus on cost savings can also unduly limit the range of social issues addressed by such contracts. In some cases, improved outcomes may be worth achieving even if the net fiscal effects are negative.[28]

Related to this is the risk that, if governments will only back a SIB if existing programmes are cut, certain parties may be put off. The philanthropic sector may not back an initiative if it entails cuts to government services, while affected parties in the public service may feel under constant threat.

Challenges for investors

Investors need to be confident that a proposed structure is robust in terms of tax, regulatory and political risks. They also need to be clear about the degree to which their own objective is commercial or philanthropic. Lack of liquidity may also concern many investors.

In 2013, UK social investment intermediary and consultancy, Investing for Good, published a 90-page *Good Investor* guide for SIB investors.[29] Based in part on consultations with nine major impact investors in the United Kingdom, the guide amply demonstrates the complexities of SIBs from an investor perspective. It is a salutary reminder of the disciplines that social impact intermediaries, providers and investors need to apply to secure better social outcomes that really improve beneficiaries' lives.

The rigorous and systematic evaluation of likely social and environment impacts will be new

24 Neil McHugh, Stephen Sinclair, Michael Roy, Leslie Huckfield and Cam Donaldson, "Social Impact Bonds: A Wolf in Sheep's Clothing," *Journal of Poverty and Social Justice* 21:3 (October 2013), pp. 247–257.

25 KPMG, "Investing for Social Success Phase One: Feasibility Study and Concept Design," op. cit.

26 Ibid.

27 Adam Jagelewski, email correspondence, op. cit.

28 Ibid.

29 Adrian Hornsby and Gabi Blumberg, *The Good Investor: A Book of Best Impact Practice* (London: Investing for Good, 2013).

territory for many investors who would otherwise be natural targets for issuers of SIBs. Measurement problems are much greater and analytical tools less well developed.

The issue of balance can also be difficult. Some charitable organisations, for example, may have arrangements that require capital investments to be fully commercial to generate income that can be used to fund charitable purposes.

Kristina Costa, et al., from the Center for American Progress, argue that potential investors most likely need to be:

- amenable to long-term timeframes for receiving a return on investment;
- confident in the government's commitment to make payments;
- notably risk tolerant (including the possibility of principal loss and lack of liquidity); and
- interested in public-private partnerships and the social issues SIBs can address.[30]

Challenges for social service providers

Service providers need to be concerned about events outside their control that adversely affect payable outcomes, and the risks of political changes or of unduly demanding bureaucratic oversight.

Many providers of social services, particularly smaller charitable organisations, may have little experience with rigorous financial or outcomes-based assessments. Interacting with investors could be a new and perhaps unwelcome experience, despite the potentially large mutual benefits.

Challenges for politicians

Delayed impact is a potential political problem, especially given the three-year electoral term. Often, a delayed impact means the full benefits – realised in savings to government and accrued from preventive measures – are not likely to be enjoyed by the government that introduced the measure. This can put public pressure on the government to intervene in SIB programmes either by ending the programme outright, or by having more direct involvement. This is why contracts need to be clear and transparent so investors are fully aware of any political risks.[31]

Even so, politicians remain responsible for social outcomes. If outcomes are not improving fast enough, public pressure might force governments to interfere directly with SIB service delivery even if it violates contractual arrangements. Politicians also remain publicly responsible for the quality of service delivery, wherein dubious practices (such as abuse, neglect or ineffectiveness) by private providers will rebound on politicians – resulting in major difficulties for future SIB contracts.

Multi-party support for SIBs is also important, where all major parties are committed to SIBs. If a major party is intent on abolishing or intervening in SIB programmes if elected to govern, both service providers and investors would face an uncertain future.

The Peterborough pilot is a good example of the political risks in SIBs, as the final cohort in the programme was cancelled due to a policy change. This termination of the first ever SIB may concern investors in future SIBs, including those keen to see the results from a completed programme.

Before the cancellation, the UK Ministry of Justice put in place a major policy reform, Transforming Rehabilitation, to support over 50 times as many people as the Peterborough SIB.[32] The Ministry said it would be unfair to hold off Transforming Rehabilitation until the Peterborough pilot ended because of the reform's much larger operating

30 Kristina Costa, et al. and the Social Impact Bonds Working Group, "Frequently Asked Questions: Social Impact Bonds," op. cit.

31 McKinsey & Company, "From Potential to Action: Bringing Social Impact Bonds to the U.S." op. cit.

32 Emma Tomkinson, "The Peterborough Social Impact Bond (SIB) Conspiracy," Blog (2014).

scale.[33] As Transforming Rehabilitation will provide similar services to Peterborough, the Ministry said it made little sense to run both.

Even though the Peterborough programme had a termination clause for situations that might render a SIB inoperable due to policy changes, SIBs simply weren't a big enough agenda item to hold the entire government machinery to ransom, according to SIBs expert Emma Tomkinson. Moreover, it wasn't specifically about shutting down SIBs but ending one particular SIB contract.[34]

Situations like this can create doubt in investors, especially commercial investors. While they may not lose money due to a programme shutting down prematurely, they may lose earning additional returns on their investment.

According to a report by the Centre for Social Impact, the Australian experience demonstrates the importance of managing potential public suspicion or hostility towards SIBs.[35] Some see SIBs as a prelude to government exiting the social sector, while others are hostile to the notion of profiteering from charitable work. Such hostility can create reputational risk for involved institutions and impede participation.

NEW ZEALAND PILOT STUDIES AND PROGRESS

The Ministry of Health is leading cross-government work to implement a SIB pilot in New Zealand.[36] The initiative arose as part of the Treasury-led Best Sourcing and Contracting work programme, which is part of the Better Public Services initiative.

Cabinet approved implementation of the pilot in August 2013 after a favourable feasibility assessment in December 2012 and a business case report in June 2013, both prepared by KPMG.

The Minister of Health's August 2013 Cabinet paper stated that the pilot's purpose would be to:

- test the SIB concept in New Zealand;
- develop the market conditions and capabilities needed in New Zealand to use SIBs more widely in the future, including growing the investor market and building the capacity of government agencies and service providers;
- learn lessons applicable to other forms of payment-for-success or outcomes-based contracting in the social sector; and
- enable government to decide whether and how to use payment-for-success and outcomes-based contracting more widely in the future.[37]

A distinctive feature of New Zealand's approach is that the Key Government has not determined in advance what social outcomes will be targeted by the pilot scheme. Instead, the Ministry has asked interested private parties to propose, and justify, specific social outcomes. The Ministry will then recommend which proposals to accept, if any. New Zealand is also apparently the only jurisdiction "where the government procured for the intermediaries and service providers separately. It is not yet clear what the benefits of this might have been or how they will be matched up."[38]

As part of its assessment, KPMG consulted potential service providers, investors and intermediaries about their willingness to participate in SIBs.[39] Responses identified a number of perceived strengths of and opportunities for SIBs.

Service providers expressed initial enthusiasm. They saw benefits from the focus on outcomes, reduced barriers to contracting across government agencies, and greater collaboration within the

33 Ibid.

34 Ibid.

35 Centre for Social Impact, "An Australian Snapshot: Social Impact Bonds," op. cit.

36 Ministry of Health, "Social Bonds – New Zealand Pilot," op. cit.

37 Ibid.

38 Emma Tomkinson, "Procurement Precedents for Social Impact Bonds (SIBs)," Blog (14 January 2015).

39 KPMG, "Social Bonds: Market Consultation" (2013).

social services sector.[40] Potential investors overall were also enthusiastic about the concept, especially investing in social issues aligned with their organisational values and community interests.[41] A promising number of organisations expressed interest in acting as an intermediary (although this interest does not necessarily reflect appropriateness for the task).

The KPMG consultations also identified potential problems. Some service providers had little commercial capability. Some investors were sceptical about the Government's intentions – better social outcomes or primarily risk transfer? Investors were also less likely to be interested in issues that require large social changes. Some raised concerns about the non-government sector's capability to manage change, and foster and sustain innovation, within the social services sector. Finally, intermediaries with expertise in financial arrangements and service provision were thought to be rare.[42]

The anticipated thinness of the New Zealand social investment market is arguably a legacy of past government procurement processes biased towards cost reimbursement. To some extent, this can be (and is) alleviated using overseas expertise. Even so, it will take time to grow local understanding and develop confidence in the capabilities of each of the contracting parties and to develop platforms and proven templates.

The thinness of the market and the Government's decision to spread the net for potential pilot cases very wide induced the Ministry of Health to engage in the prolonged multi-step matching and procurement process summarised in Box 1. The Government's desire to gather information about potential interest widely across the social services sector is understandable; of course, set-up costs have to be higher for a path-breaking pilot than for one adopting a proven template.

There is also a logic for a match-making process in a thin market where parties have not previously worked together. Nevertheless successful match-making is a challenge, albeit one among many. Some concerns have been expressed to us during the course of this research about the drawn out and bureaucratic processes. The challenges are real but we remain hopeful for a good outcome.

THE NEW ZEALAND INITIATIVE

40 Ibid.

41 Ibid.

42 Ibid.

THREE
SIBS OVERSEAS

SIBs are a relatively new concept, both in New Zealand and abroad. As of August 2014, 25 SIBs had been commissioned in total, in seven different countries.[43] Many other countries are exploring the potential for adopting SIBs. This chapter focuses on cases from the United Kingdom, Australia and United States, as these cases were sufficiently developed to offer constructive lessons for New Zealand. However, there are some lessons from Canada that feature in Chapter 4, but are not discussed in-depth below.

THE UNITED KINGDOM

By August 2014, 15 SIBs had been launched in the United Kingdom. Of these, 10 were launched by the Department for Work and Pensions using a government Innovation Fund, and the remaining by the Ministry of Justice, Essex County Council, the Greater London Authority, Manchester City Council, and the service provider It's All About Me Adoption Bond.[44]

The United Kingdom has a well-established social finance market, with a number of independent financial institutions aimed at growing the sector. These institutions often serve two functions: to act as an investor and as a champion for social investment. In this context, SIBs are not much of a stretch from other forms of social investment.

The UK investment market for SIBs so far has been dominated by investors from philanthropic foundations investing in projects closely aligned with their traditional social objectives, but now offering the ability to test for innovation and potential for scale.[45]

Table 1 summarises the outcomes targeted and measured by UK SIBs so far, while Appendix 2 describes how SIBs have been funded in the United Kingdom.

To date, no mainstream institutional investor has invested in SIBs in the United Kingdom, reflecting the risk/return profile, lack of scale, or lack of track record of the model. While a number of investment banks have begun to show interest in either investing their own capital or trying to structure SIBs, this has yet to eventuate.[46]

RAND Europe's independent inquiry into the Peterborough pilot (see below) identified a number of impediments faced by investors, including the following:

- Social bonds are still unproven, have no track record, and therefore present a significant risk to investors.
- There are outcome measurement difficulties. Because conventional finance markets do not price social value creation, there is a lack of comparable performance information (metrics) to support the creation of a new or modified social investment marketplace.
- There is a lack of a secondary market for social investments that would allow investors to sell their bond, thereby increasing liquidity.
- There is a lack of clarity with the current charity investment guidance as to the balance between

43 Social Finance UK, "The Global Social Impact Bond Market," op. cit.

44 Ibid.

45 Daria Kuznetsova and Jenna Palumbo, "Social Impact Bonds: Lessons Learned," *Social Investment Insights Series* 2 (London: Big Society Capital 2014).

46 Ibid.

accepting a blended return on investment (social outcomes and financial outcomes), and the fiduciary obligation of trustees to maximise return on investment.

- The tax incentives and tax rules facing charities may also prove problematic. In the Peterborough case, charities could receive outcome payments as donations by investing through Social Finance UK, a charity feeder instrument.[47]

According to Big Society Capital, an independent social investment institution, retail demand for SIBs remains low, as qualified private investors await outcomes from the initial round of SIBs before deciding whether SIBs are appropriate for clients.[48]

UK Government initiatives and regulatory reform

The UK Government has actively committed to improving the social investment sector through policy initiatives and regulatory reform. According to a government report, "Growing the Social Investment Market: 2014 Progress Update," as the sector develops, so will support for SIBs. The strategic challenge for the Government is now to build on existing progress and increase mainstream social investment.[49]

Table 1: SIBs in the United Kingdom

Commissioner	Outcome	Outcome measure
Ministry of Justice	Reduced reoffending (recidivism rate)	Number of conviction events in 12 months after release
Department for Work and Pensions	Improved youth employment, education attainment, and/or job training	Several outcome measures (involving 10 distinct SIBs)
Essex County Council	Children in less need of care	Number of days in care
Greater London Authority	Reduced homelessness	Multiple outcomes, including reduced rough sleeping, more moves to settled accommodation, more reconnections abroad, increased employment, and fewer A&E hospital visits
Manchester City Council	Reduction in the number of children in care	Number of weeks a young person stays out of care, and other well-being outcomes
It's All About Me Adoption Bond (first supplier-led SIB)	Increase in adoption rate	Number of children achieving successful, lasting adoptions Outcomes payments are paid upon the achievement of four separate milestones, each of which is both an outcome in its own right, and indicative of the direction travelled towards the ultimate outcome of a successful, lasting adoption

Source: Centre for Social Impact Bonds, "Case Studies – Existing SIBs" (London: 2013).

47 Emma Disley, Jennifer Rubin, Emily Scraggs, Nina Burrowes, Deirdre May Culley, "Lessons Learned from the Planning and Early Implementation of the Social Impact Bond at HMP Peterborough," Technical report prepared for the UK Ministry of Justice (Cambridge, UK: RAND Corporation, 2011).

48 Daria Kuznetsova and Jenna Palumbo, "Social Impact Bonds: Lessons Learned," op. cit.

49 HM Government, "Growing the Social Investment Market: 2014 Progress Update" (London: Ministry for Civil Society, 2014).

The UK Government has undertaken a considerable number of initiatives to increase investment supply and diversify the investor base.[50] While not all such initiatives would be applicable or appropriate for New Zealand, the initiatives below illustrate the extent of the UK Government's work to build social investment infrastructure. The UK Government:

- partnered with independent financial institutions to establish the Social Investment Research Council. The council works on research such as improving the understanding of social investment products and investors.[51]
- announced in 2014 a Social Investment Tax Relief to incentivise retail investment, wherein "individuals making an eligible investment can deduct 30% of the cost of their investment from their income tax liability." Three key reasons formed the rationale for this tax relief. First is to ensure that high risk capital reaches social as well as mainstream enterprises, especially because social investment has traditionally fallen outside the remit of existing tax regimes as it is neither philanthropy nor commercial investment. Second, the tax relief to individuals is based on the need to meet anticipated demand for high risk capital. Lastly, the opportunity cost of not meeting society's and government's growing need for services through a shortage of investment is measured in terms of the lost economic and social benefit.[52]
- funded "social incubators to provide business support to social ventures specialising in market infrastructure." These included a Social Investment Index, a Platform for Wealth Managers, a Post-Accelerator Fund, and a Social Venture News Channel.[53]
- "released an open data platform detailing social investments made by UK charitable foundations. The code for this work is available in an open source repository and is freely licenced, enabling replication for other data projects."[54]
- has also set up a number of initiatives to increase demand for investment and support more targeted investment readiness. For example, to increase awareness, the Government worked with the Design Council to "map sources of funding for investment readiness support." The Government also "supported the development of an online marketplace of impact tools and resources. [These include] the Inspiring Impact digital platform, [which incorporates] an impact self-assessment tool designed to help social ventures determine which areas they need to strengthen, and a marketplace for social ventures to help locate the impact measurement tools they need."[55]

Cabinet Office established a Social Outcomes Fund in November 2012 to reduce the "difficulty of aggregating [the accrued] benefits and savings across multiple public sector spending 'silos' in central and local government."[56] This fund may supplement financial contributions to outcomes-based commissions such as SIBs and other payment-for-results contracts. Funding is only available in England, to government departments, local councils, and other commissioning bodies. Additionally, the Cabinet Office offers an Investment and Contract Readiness Fund, which is managed by Social Investment Business, one of the largest social investors in the United Kingdom.

The government's Big Lottery Fund has launched the Commissioning Better Outcomes Fund "to support the development of more innovative approaches to improving social outcomes."[57]

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50 Ibid.

51 Ibid.

52 Worthstone, "The Role of Tax Incentives in Encouraging Social Investment" (London: City of London and Big Society Capital, 2013).

53 HM Government, "Growing the Social Investment Market: 2014 Progress Update," op. cit.

54 Ibid.

55 Ibid.

56 HM Government, "Guidance: Social Impact Bonds" (London: Cabinet Office, 2012).

57 Ibid.

Like the Social Outcomes Fund, the Commissioning Better Outcomes Fund tops up the outcomes-based payments of SIBs. Additionally, it provides some funding towards the development of SIBs that have passed the Expression of Interest stage.

The Innovation Fund was set up by the UK Department for Work and Pensions. Ten SIBs were commissioned after two rounds of open competition tested "a range of social investment and innovative delivery models." The comparative results of these 10 SIBs will "inform future policy decisions." The Innovation Fund is the first time SIBs have been procured via open competition in the United Kingdom.[58]

Another government initiative that has helped develop SIBs in the United Kingdom is the development of a Unit Cost Database for a variety of government-provided social service outputs and outcomes. Developed in partnership with think tank New Economy Manchester, this database contains more than 600 cost estimates (fiscal and social) for crime, education and skills, employment and economy, fire, health, housing and social services.[59]

Eccles, founder of Social Finance UK, says the Unit Cost Database will greatly improve the use of top-up funds such as the Social Outcomes Fund, Big Lottery Fund, and Commissioning Better Outcomes Fund.[60] In fact, this information has already helped inform SIB proposals, feasibility studies, and evaluations in the United Kingdom. One of the issues with SIBs is that most interventions have a variety of social outcomes that affect, and add value to, different parts of the government. Unit cost data can help inform the value of these additional benefits. Unit cost data can also add a layer of consistency, as all SIB applicants use the same data, making it easier to compare the numbers they are using. This makes the assessment of applications quicker and more accurate.

Peterborough Prison

The Peterborough Prison SIB, the world's first SIB, was launched in the United Kingdom in September 2010 to reduce the recidivism rate of newly released prisoners. Private investors funded a range of individually tailored rehabilitation services, and earned a financial return based on their success in reducing recidivism, in proportion to the degree that rates of re-offending reduced.

Commissioned by the Ministry of Justice and managed by the intermediary Social Finance UK, the Peterborough Prison SIB involved multiple charities. Services were coordinated by ONE Service, a special vehicle set up by Social Finance UK for the pilot, to provide intensive and individualised support to ex-prisoners who could voluntarily enrol.[61] The interventions were to ensure "adequate and permanent housing; drug and alcohol treatment; employment assistance; parenting assistance; mental health support; and peer network support." Investors included a number of foundations and trusts with a strong social focus.[62] The University of Leicester and QinetiQ were appointed as evaluators to verify the results.

This inaugural pilot attracted intense interest, leading to a degree of monitoring and reporting that became burdensome on providers, according to one source we spoke to.

Essex County Council

The Essex County Council SIB was different from other SIBs in the United Kingdom in that the funds paid for success came directly from the area

58 Centre for Social Impact Bonds, "Department for Work and Pensions Innovation Fund," Website (London: Cabinet Office, 2013).

59 Toby Eccles, "Valuable Numbers," Blog post (London: Centre for Social Impact Bonds, Cabinet Office, 18 February 2014).

60 Ibid.

61 Social Finance UK, "Peterborough Social Impact Bond Reduces Reoffending by 8.4%; Investors on Course for Payment in 2016," Press release (London: 7 August 2014).

62 Centre for Social Impact Bonds, "Ministry of Justice: Offenders Released from Peterborough Prison," Website (London: Cabinet Office, 19 April 2013).

where money was saved. It was also the first SIB to provide Multi-Systemic Therapy services in the homes of vulnerable children.[63] The targeted outcome was a reduction in the number of days children had to be placed under local authority care. Success payments were linked to cost savings. The payment mechanism was also unique in that it facilitated earlier repayment of amounts invested, lessened investor risk exposure, and controlled return rates. Additionally, the SIB allowed a "collaborative approach between the service provider and existing care services, where providers had access to local authority case management systems to ensure high quality and mutual data exchange."[64]

Greater London Authority

The Greater London Authority SIB focused on outcomes for homeless people. The service providers provided part of the upfront funding. This meant they shared the risk with investors, as well as potential returns. The SIB was also unique in that it held a 'Dragons' Den' style of investment event, designed to match likely social service bidders with potential social investors. "This allowed commissioners to facilitate introductions between social investors and shortlisted providers, discuss the proposed tariffs for the outcome metrics, as well as explore and comment on service solutions proposed by the shortlisted providers."[65]

Scotland's Living Balance SIB

The Living Balance Project SIB under the Department for Work and Pensions in Scotland is focused on improving outcomes for youth not in employment, education or training.

Service provider YMCA Scotland deliberately targeted business investors who are motivated by social impact to not only provide funds but also to offer work experience and mentorship to young people.[66] It was encouraged by the willingness of local investors to step up and get involved, and by the growing interest in the local approach used.[67]

This "very different model that rejects distant investors whose sole interest is financial" is showing early signs of success. In fact, "reducing the return to investors has not reduced the interest of investors." Rather, bringing investors closer to participants has increased their interest in how direct relationships can improve outcomes.[68]

Most other SIBs, though, do not involve such a high level of direct investor involvement.

What are the interim results of SIBs to date?

The Peterborough programme worked with 3,000 offenders split into three cohorts of 1,000 each. Results for the first cohort of 1,000 prisoners, released in August 2014, "showed an 8.4% reduction in re-offending among the intervention group compared to the national average." Importantly, there was evidence of a rising success rate, perhaps reflecting increasing experience and learning-by-doing. If the same results were achieved by the second and third cohorts, investors would have got their money back, plus a positive return in 2016.[69] We have not seen an assessment of the full costs incurred under this programme.

However, in April 2014, the Ministry of Justice announced the early end of the Peterborough pilot due to wider government restructuring of probation service provision nationally. Due to this restructuring, the Ministry of Justice deemed it would be too "difficult to ensure the pilot had sufficient freedom to operate" after a new contractor

63 Centre for Social Impact Bonds, "Essex County Council: Children at Risk of Going into Care" (London: Cabinet Office, 19 April 2013).

64 Ibid.

65 Centre for Social Impact Bonds, "Greater London Authority: Homeless People" (London: Cabinet Office, 19 April 2013).

66 YMCA Scotland, "Social Impact Bonds," Press release (6 March 2013).

67 Ibid.

68 Ibid.

69 Social Finance UK, "Peterborough Social Impact Bond Reduces Reoffending by 8.4%; Investors on Course for Payment in 2016," op. cit.

took over responsibility for the rehabilitation of prisoners.[70] Despite these changes, the Ministry of Justice has expressed its intention to "structure transitional arrangements to ensure the pilot completes its work" with the second cohort.[71]

The Ministry of Justice has agreed to fund "an increasing proportion of the costs of the service to reflect the increasing proportion of the case load represented by the third cohort." The Big Lottery Fund has also agreed to support the pilot until work with the second cohort is completed. These arrangements will ensure investors "continue to fund the costs of working with the remaining members of the second cohort," but on a decreasing basis to reflect the decreasing case load for the cohort. This will also ensure their original investment will be rewarded on the same basis as initially envisaged, except that investors will not have the opportunity to earn a return for working with the third cohort. In addition, the Ministry of Justice has agreed to pay the termination costs.[72] The implications of this first pilot for New Zealand's own SIB model are addressed in Chapter 4.

AUSTRALIA (NEW SOUTH WALES)

Two SIB projects (known as 'Social Benefit Bonds' in Australia) are in progress in New South Wales. Both focus on strengthening families and reducing the need for foster care. Procurement for both bonds was by open process to public tender, based on two specific priority areas: out-of-home care and criminal recidivism. However, the Request for Proposal was not prescriptive, so applicants could develop details around target cohorts, outcome measures, savings estimates, and service models.[73] Table 2 summarises the outcomes measures for the two bonds.

A third SIB, on recidivism, had been approved but was pulled at a very late stage.[74] NSW Treasurer Andrew Constance rejected the claim that "there was less political will to back the initiative aimed at helping convicted prisoners than there was for the [two] other bonds funding support for vulnerable children." Rather, he argued, "Bureaucracies and governments move slowly."[75]

Table 2: SIBs in Australia

SIB	Outcome	Outcome measure
Newpin: Children in out-of-home care	Strengthening families	"Rate and number of children restored to families as well as children who re-enter out-of-home care after initially being restored Number of prevented entries to out-of-home care for families at risk of having a child removed."[76]
Benevolent Society	Strengthening families	Reduction of number of children involved in child protection system.

Sources: Centre for Social Impact Bonds, "New South Wales Government: Children in Out-of-Home Care" (London: Cabinet Office, 19 April 2013); Centre for Social Impact, "An Australian Snapshot: Social Impact Bonds" (Sydney: 2012).

70 Ibid.

71 Ibid.

72 Ibid.

73 KPMG, "Joint Development Phase of the NSW Social Benefit Bonds Trial" (2014).

74 Sally Rose, "Wait continues for social benefit bonds decision," *The Sydney Morning Herald* (17 September 2014).

75 Ibid.

76 Centre for Social Impact Bonds, "New South Wales Government: Children in Out-of-Home Care" (London: Cabinet Office, 19 April 2013).

How have SIBs been funded?

For a full breakdown of how the NSW bonds were funded, see Appendix 3.

According to the Australian university-based Centre for Social Impact (a collaboration between the University of New South Wales, Swinburne University of Technology, University of Western Australia and University of Melbourne), the characteristics of the target social investors for the NSW pilot fell within three main categories:

- philanthropic, high net-worth individuals willing to explore moving from traditional donations or grants to 'invest' and potentially reinvest the same capital for social purposes;
- "[a]lready socially engaged [ethical, socially responsible, sustainable and green] investors motivated to consider a commercial opportunity to align a return on investment and a social impact focus"; and
- the 'gatekeepers' of large corporate trustee groups.[77]

Within these groups, the Centre for Social Impact identified a number of other general characteristics of those investing in the SIB pilot:

- investors attracted to new and innovative investment models, and specifically seeking to be among the first Australians to invest in a SIB;
- investors with the capacity to invest the minimum amount for the minimum term; and
- investors located in or associated with NSW.[78]

A breakdown of investors (Table 3) shows that corporates and financial institutions were more likely to invest in the more protected, less-risk P (protected) class, rather than the higher-risk E (equity) class. Meanwhile, not-for-profits invested more in the higher-risk E (equity) class. The P class protects the investors' initial investment while offering a lower rate of return, while the E class puts the investors' entire capital at risk, while offering a higher rate of return.

Table 3: Investor categories in the Benevolent Society bond

Type of investor	Tranche (P class) Percent of total invested	Tranche (E class) Percent of total invested
Corporate	13.3	6.0
Ethical institution	6.7	6.7
Financial institution	34.7	26.0
Foundation	12.7	22.0
Individual	23.3	26.0
Not-for-profit	6.7	20.0
Trust	2.7	0
Total	A$7.5 million	A$2.5 million

Source: KPMG, "Joint Development Phase of the NSW Social Benefit Bonds Trial" (2014).

What are the interim results of SIBs to date?

The Centre for Social Impact advises that even at this early stage, government processes have been encouraged to reform, due to the greater emphasis placed on outcomes, transparency and contracting in SIBs. In other words, SIBs have been a positive example for other government processes to follow.

Service providers have also purportedly benefited from the trial, especially the use of cost-benefit analysis in service delivery. Moreover, the Benevolent Society has reported the benefit of gaining experience in performance based contracting, and learning about their own performance by comparing their service outcomes with government data.[79]

77 Centre for Social Impact, "Report on the NSW Government: Social Impact Bond Pilot" (Sydney: 2011).

78 Ibid.

79 Centre for Social Impact, "An Australian Snapshot: Social Impact Bonds," op. cit.

THE UNITED STATES

In the United States, 'Payment-for-Success' refers to social service contracts where the government pays service providers for successful outcomes (as distinct from outputs). Another term, 'Social Innovation Finance,' refers to the finance investors provide to service providers to bridge the gap between service provision and government payments for success. When such arrangements involve outside investors and include Payment-for-Success contracts, the overall arrangement may also be called a SIB.[80]

Broad areas of activity comprise public safety and recidivism, rough sleeping and chronic homelessness, health (asthma), and children and families. These areas are not exhaustive. One private sector group uses Payment-for-Success programmes to reduce wildfires on public land.[81]

Silicon Valley investors and related philanthropists have been active in applying the venture capital model to non-profit social sector organisations such as Legacy Venture, Silicon Valley Social Venture Fund, Social Venture Partners International, and the NewSchools Venture Fund.[82]

Several foundations in the Silicon Valley are supporting private sector agencies to work with Santa Clara County to introduce Payment-for-Success programmes to reduce local poverty.[83]

Harvard University's Kennedy School has established a SIB Technical Assistance Lab to promote uptake with help from the Rockefeller Foundation. Goldman Sachs has been an enthusiastic early investor. Organisations of substance are keen to act as intermediaries and/or providers.[84] Notable ones include Social Finance US, Third Sector Capital Partners, and Investing for Good.

80 Third Sector Capital Partners, "What is Pay for Success?" Website (2014).

81 See Private Capital for Public Good, Website.

82 See Stanford University, "Social Venture Funds," The Recent Graduate's Nonprofit Career Database, Website.

83 See T*hird Sector Capital Partners, From Idea to Action: Pay for Success in Santa Clara County* (18 November 2013), p. 1.

84 See Wikipedia, "Social Impact Bond," Website.

According to a February 2014 publication by US think tank Center for American Progress, 13 states were actively exploring Payment-for-Success options. Several of these states have introduced enabling legislation.

The first four Payment-for-Success programmes to be launched in the United States were:

- *New York City's four-year, US$9.6 million bond* launched in August 2012. It aims to reduce recidivism among juvenile offenders released from Rikers jail;
- *Utah's seven-year, US$7 million bond* launched in August 2013. It aims to enhance pre-school education for at risk 3- and 4-year-olds;
- *Massachusetts' seven-year, US$27 million bond* launched in December 2013. It aims to reduce juvenile offender recidivism; and
- *New York State's 5.5-year, US$13.5 million bond* launched in December 2013. It aims to reduce recidivism and increase employment among 2,000 offenders.

Goldman Sachs was the sole financier in the New York City bond ($7.2 million was guaranteed by Bloomberg Philanthropies). Goldman Sachs was also the major investor in the Utah bond. Payments depend on fiscal savings for the state. Ninety percent of savings are paid out until capital has been repaid with 5% interest. After that, investors receive 40% of any additional savings.[85]

Goldman Sachs invested US$9 million in the Massachusetts bond. If the project achieves its target of 40% reduction in days of incarceration, Goldman Sachs will receive an annual return of 5% and up to another US$1 million if the target is over-achieved. Other major investors and the service provider can also hope to receive bonus payments for exceeding the target.[86]

85 Ann Griffiths and Christian Meinicke, "Introduction to Social Impact Bonds and Early Intervention, Initial Report" (Early Intervention Foundation, April 2014), p. 30.

86 See Goldman Sachs, "Fact Sheet: The Massachusetts Juvenile Justice Pay for Success Initiative" (undated).

New York State's bond attracted around 40 qualified institutional and private investors through an offering using Bank of America Merrill Lynch's wealth management platform. The maximum potential annual return is 12.5%. The Rockefeller Foundation guaranteed a capital of $1.3 million.

Social Finance US was the chosen intermediary for the New York State bond; Third Sector Capital Partners was the lead intermediary for the Massachusetts bond; and the Vera Institute of Justice was chosen to provide an independent valuation in the New York City bond.

In successive budgets since 2011, President Obama proposed federal spending allocations for SIBs of the order of $100 million to $300 million, but Congressional acceptance has been lacking.[87]

Even so, there is evidence of widespread bipartisan enthusiasm for Payment-for-Success bonds in the United States. Acknowledging the limited scale, but high promise, of SIB activity to date, two federal legislators introduced a bipartisan Social Impact Bill, H.R. 4885, to the House of Representatives in June 2014. The bill aims to extend the SIB model across all three layers of government.[88] If enacted, the legislation would create a US$300 million fund to support state and local bonds, and establish an inter-agency council to promote local initiatives proposing to save federal dollars.[89]

RESULTS TO DATE – TOO EARLY TO TELL

Sceptics point out that the track record of social bonds is unproven. US columnist Rick Cohen, author of the "The Cohen Report," published several articles in the online *Nonprofit Quarterly* in 2014 aimed at diminishing overly exuberant expectations.[90]

His July 2014 article stated that none of the US examples or the UK Peterborough prison pilots had reached their first payment points. Another of his concerns is that governments, being politically risk averse, are inclined to select proven providers of established programmes, thereby shutting out unproven providers of risky but innovative programmes. Cohen points out that outcomes such as rates of recidivism might depend on the performance of entities that are not party to SIB contracts. Dysfunction could result. He also doubts whether some investors have provided value-added commensurate with the returns they are likely to receive. He considers that there is a need to establish that incentives through tax credits or government funding would not be more economic.

The Policy Innovation Research Unit (PIRU), funded by the UK Department of Health, published a substantial review of the literature this year on the empirical benefits to date from SIBs and, indeed, payment-for-results contracts more generally.[91]

A sobering observation was that "there remains a dearth of evidence for the assertion that SIBs will lead to improved outcomes.' It also found "no consensus in the literature on whether SIBs are best suited to innovation or 'scaling up'.' The empirical section of the review concluded:

> The empirical studies highlight the high transaction costs of SIBs, the complexity of data monitoring and measurement as well as the ability for SIB delivery to offer space for innovation to service providers and improved outcomes as exemplified by the first outcome findings from the Peterborough SIB.[92]

87 Sonal Shah and Kristina Costa, "Social Impact Bonds: White House Budget Drives Pay for Success and Social Impact Bonds Forward" (Washington, DC: Center for American Progress, 23 April 2013).

88 See Todd Young (Indiana Congressman), "Reps. Young and Delaney Introduce Social Impact Bond Act," Website (18 June 2014).

89 See John Griffith, "How Social Impact Bonds Can Help Bring Private Dollars to Low-Income Communities," www.enterprisecommunity.org (9 September 2014).

90 Rick Cohen, "Eight Sobering Thoughts for Social Impact Bond Supporters" (12 June 2014); "Social Impact Bonds: Phantom of the Nonprofit Sector" (25 July 2014); "Thoughts on Making Social Impact Bonds Work – If They Should At All" (31 July 2014); "Ways and Means Committee Hearing on Social Impact Bonds Gets Little Attention" (16 September 2014); "Does 'Pay for Success' Actually Pay Off? The ROI on Social Impact Bonds" (17 October 2014), N*onprofit Quarterly*.

91 Stefanie Tan, et al., "An Evaluation of Social Impact Bonds in Health and Social Care Interim Report," op. cit.

92 Ibid. p. 25.

FOUR
APPLICATION TO NEW ZEALAND

ISSUES

The most important lesson for New Zealand from overseas experience is that SIBs involve multiple players, agreements and contracts, creating great complexity (see Appendix 1).

As an example, the Peterborough SIB took 18 months to set up, and required the equivalent of 2.5 years of staff time and 300 hours of legal and specialist tax advice.[93] While this was mainly because some of the legal structures had to be built from scratch, it does illustrate the time and effort that needs to go into building the support infrastructure. Social Finance UK warns that if SIB models remain resource intensive, and require large and specialised bid teams, private and charitable investors may be deterred.[94]

Some of the issues that need to be addressed are:

- Finding projects for which target social outcomes can be meaningfully set and satisfactorily measured, and where the costs of preventive action are less than the costs of remedial services;
- Finding projects capable of attracting private investors doing more than just allowing the government to borrow at a higher cost than it would from wholesale market borrowing;
- Designing efficient contracts between government agencies and SIB intermediaries, and between those intermediaries and service providers and private suppliers of capital;
- Building capability among intermediaries, service providers, social entrepreneurs, philanthropists, investors, government agencies, and legal and tax advisers to 'know the ropes';
- Building platforms facilitating information sharing, fundraising and monitoring of projects;
- Creating ability to scale; and
- Addressing political and bureaucratic risks apart from normal investment and social service risks.

In drawing lessons about how best to deal with these issues, New Zealand's small size and relatively thin capital markets need to be borne in mind. Initially, there is likely to be only a limited number of parties with the sophistication and capacity to pull their weight in a SIB programme.

Even in the United Kingdom, a country of scale and highly sophisticated financial markets, the Government deemed it necessary to actively promote SIB activity and set up central government agencies to reduce the costs to private parties of dealing with multiple government agencies.

The case for such leadership is just as strong in New Zealand where government is the dominant party in relation to providing social services, and the average level of sophistication among social service agencies is lower, reflecting less scale and thereby capacity.

Nevertheless, the UK Peterborough pilot demonstrates the potential significance of political and bureaucratic risks when dealing with governments. Projects can easily become redundant when political or bureaucratic circumstances change. Bureaucratic monitoring can become too costly and intrusive for service providers to cope with based on the number of government agencies involved and the degree of

93 The Robertson Trust, "Social Investment in Scotland: A Funder's Perspective on Public Social Partnerships and Social Impact Bonds" (2012).

94 Ibid.

public and political interest in how the project is working out.

The UK Government's interest was, at least initially, more in tapping outside funding to ease its own capital constraints than in tapping the value outside investors might add through their knowhow and managerial expertise. In New Zealand, there is no obvious case for government to borrow minute sums in thin capital markets, when it can borrow more cheaply in much deeper global markets.

New Zealand needs to focus on finding investors who can add value to a SIB beyond the provision of capital. Scotland's Living Balance SIB (discussed in Chapter 3) is of particular interest in this respect for seeking business investors who were also likely to help young people get jobs.

LESSONS

Lessons we draw for the development of the market in New Zealand include the importance of:

- government leadership and promotion to initiate and develop the market for SIBs involving government procurement;
- avoiding allowing political or bureaucratic risk aversion (the fear that a pilot SIB might fail or cause embarrassment) to stifle delivery freedom;
- avoiding monitoring regimes that impose burdens on service providers that impair their capacity to achieve performance targets; and
- ensuring that government laws and regulations do not unnecessarily inhibit the development of private initiatives to develop SIBs independently of government.

POSSIBILITIES FOR NEW ZEALAND

As the international case studies have illustrated, SIBs have been designed and implemented in diverse ways. As well as incentivising innovation in service delivery, the concept of SIBs itself has evolved markedly since its inception. As SIBs and other forms of impact investing become more mainstream, it is likely to evolve further. It is also possible for New Zealand to be an exemplar to other countries, as New Zealand's regulatory structures allow innovations not possible elsewhere. Here are four possible ways the SIB model could evolve and enhance the likelihood of its success in New Zealand.

Establish a special unit out of the Treasury

The current SIBs pilot is being led by the Ministry of Health as a cross-government initiative. However, overseas case studies have illustrated that the commissioner (the person or organisation purchasing the service) does not have to be a department or ministry. Theoretically, the SIB model allows private parties to approach the government with proposals for social outcomes they could achieve, and then negotiate the terms of contract.

A special Treasury unit, independent from any one ministry, could be set up to work across the public sector to approve SIB programmes, approve funding, and agree to terms of contract. This unit would be similar to the Office of Social Impact Investment (OSII) in NSW.

BOX 2: NSW OFFICE OF SOCIAL IMPACT INVESTMENT (OSII)

The NSW Office of Social Impact Investment (OSII) is a joint initiative of the NSW Treasury and the NSW Department of Premier and Cabinet (DPC). It was established as one of the initiatives by the NSW Government to facilitate growth in the social impact investment market.

The OSII oversees and leads the implementation of the NSW Social Impact Investment Policy, working closely with other government agencies and non-government stakeholders. Key elements of this work include developing new social impact investment transactions and helping to build the capability and capacity of agencies and others to participate in the social impact investment market.

The OSII is the central point of contact for organisations that want to work with the NSW Government on social impact investment.

Source: NSW Treasury, "Social Impact Investment," Website.

Treasury can coordinate across departments where several sectors have an interest. For example, the Department of Police, Department of Corrections, Department of Justice, and Ministry of Social Development are all interested in reducing the recidivism rate. Treasury is also the spending control department across the public sector, so it can best assess fiscal savings across sectors.

A special Treasury-led unit could also deal with problems of cross-agency funding. Often, the social outcomes that SIBs address are multi-faceted and involve a number of sectors. Deciding how to allocate funding and which sectors will accrue fiscal savings can be difficult to earmark. The unit could also reduce transaction costs. For private parties, it would provide a one-stop shop to interact with, rather than dealing and coordinating with multiple bureaucracies.

The unit could address some of the challenges faced in approving SIBs. There are a number of drawbacks in having special interest departments and ministries lead the process of approving SIB programmes. The first is 'turf protection,' where independent departments or ministries may be reluctant to approve promising SIB projects for fear that these projects will threaten or displace current public sector provision. If the SIB is a success, it could call into serious question why the public sector failed to achieve similar or better results – and put individual jobs or government funding at risk. When a government is aiming for zero-budgeting, as the current National government is, any new initiative like SIBs must be funded by cutting spending in some other programme.

American economist William A. Niskanen has demonstrated how discretionary budget-maximising bureaucracies can skew outcomes away from those desired by legislators and the public.[95] Bureaucracies have an incentive to perpetuate themselves and their budgets as their livelihoods depend on it. This means public sector agencies may be suspicious of the private sector parties that may displace them or apply pressure through direct competition. If the same bureaucracies are in charge of approving projects, they could simply stymie the projects they don't like.

Government agencies too have little real incentive to measure outcomes in relation to their expenditures in order to save taxpayer money. By focusing attention on performance in relation to outcomes, SIBs can expose existing data limitations and thereby ill-justified fiscal spending.

Finally, even if bureaucracies intend to support SIBs, they may not have the capacity to give it due attention because of competing priorities. A project may be neglected for lack of designated project champions.

95 William A. Niskanen, "Bureaucracy and Representative Government" (Chicago: Aldine-Atherton, 1971), in Dennis C. Mueller, Public Choice III (Cambridge: Cambridge University Press, 2003).

A likely obstacle in setting up a special Treasury unit is that it may fail to get the affected ministries and departments on board with SIBs. But cooperating with the public sector, and letting ministries and departments have input in the project, doesn't just have to be a sign of good faith – it could help government departments unduly interfering in SIBs. Getting departments on board may also ease some of the anxiety they may suffer over taking political risks. They are the ones who will face public scrutiny if a programme does not do well, so such anxiety is understandable. If they don't have any input, departments may feel even more compelled to intervene with the programme, for fear that they would still be held accountable if anything went wrong, or the public perceived something was going wrong, with the programme.

A Treasury-led team that included SIBs senior representatives from all the major ministries and departments (such as Justice, Social Development and Corrections) could provide the specialist expertise needed and bridge the gap of information silos.

Explore possibilities for crowdfunding

Full or partial crowdfunding of SIBs is a prospect for New Zealand. While not appropriate for all projects, crowdfunding can be used to supplement more conventional SIB funding and to reveal the degree to which small projects enjoy widespread support, perhaps by local communities. It can thereby inform governmental and other decision-making. For example, the New Zealand Film Commission actively encourages crowdfunding campaigns in order to work out what projects are likely to be publicly supported and successful.

Investopedia succinctly, but perhaps over narrowly, defines crowdfunding as the use of small amounts of capital from a large number of individuals to finance a new business venture.[96]

Typically a project initiator uses an internet platform to economically access potentially vast networks of friends, family, colleagues, acquaintances, fans, customers and supporters – even the world at large. Commonly, an 'all-or-nothing' fundraising target is set, and the initiator gets zero funding if the target is not reached. The incentives to contribute may take the form of a debt or equity interest in the project or a product- or service- related award. Several hundred crowdfunding platforms exist globally, with Kickstarter being one of the best known and most active.

Being a form of capital raising, crowdfunding is subject to capital market and securities market regulatory restrictions of varying degrees internationally. Crowdfunding may have an edge in New Zealand in that the Key Government wants to help "businesses grow by reducing barriers to investment." Businesses can now "raise up to $2 million through crowdfunding each year without having to issue a prospectus or investment statement."[97]

As a result, New Zealand's regulatory regime may allow crowdfunding to complement the SIB model, even though such a combination has not been tested overseas.

Crowdfunding is already established in New Zealand. Givealittle and PledgeMe are crowdfunding platforms in New Zealand that assist with community projects and help volunteers travel overseas or to conferences/forums. Many of the projects are small-scale, with the average project raising $5,000 in funds. Indeed, there is an emerging social enterprise sector in which social enterprise organisations exist to help strengthen the sector's ability to achieve social or environmental goals through commercial and non-commercial means.

96 Investopedia, "Crowdfunding," Website.

97 Business.govt.nz, "Important Changes from 1 April," Website (April 2014).

BOX 3: THE ĀKINA FOUNDATION

The Ākina Foundation is on a committed mission to grow the emerging social enterprise sector in New Zealand. Social enterprise covers social-purpose ventures which deliver measurable social impact. Ākina approaches this mission by activating talent, building capability and supporting high-potential enterprises access the capital and markets they need to fulfil their potential.

Social Impact Bonds (SIBs) are an instrument that combines two essential components that social enterprises need to succeed – investment capital and markets. The primary innovation is market creation – enabled through the direct purchase of social impact based on an agreed cost-benefit value of any given outcome and transparent impact measurement and reporting.

Ākina supports the principle of SIBs with many of them tracking well around the world. However our real interest focuses on how they work in practice and how principles they represent can be made more efficient to administer – and, therefore, more accessible to suppliers and purchasers of outcomes alike.

If the primary innovation is purchasing outcomes, how do we enable government (and other purchasers) to be responsive to a wider market of propositions from social enterprises and service providers? If compliance costs can be reduced, smaller contracts become viable and more innovation becomes possible. If there is an expanded market for outcomes, the investment side of the equation will take care of itself without undue intervention or engineering.

Perhaps special procurement funds within government departments married with a set register of cost-benefit values (like the UK Government's Unit Cost Database) could help catalyse a whole new market. This is what Ākina feels we should be aiming for – a whole social investment market where the purchasing of results is directed at the most effective services and resourced by a new impact capital market.

– Alex Hannant, Chief Executive, Ākina Foundation

The Ākina Foundation (see above), which assisted us with our research, is one such organisation in New Zealand supporting and strengthening the social enterprise sector. It also helps people "build validated business models and investment strategies to enable [social enterprise] to grow and develop their enterprise."[98]

Such support and expertise could be tapped by organisations wishing to set up SIBs. Crowdfunded SIBs, backed by either government or a philanthropic supporter (see next section for more information), can provide an outcome-contingent return to investors, while organisations like Ākina can help establish the contractual boilerplate to structure the investment vehicle and serve as a critical repository of developing institutional expertise.

98 The Ākina Foundation, "Overview," Website.

REPLACING THE GOVERNMENT'S ROLE WITH PHILANTHROPY

Given the political risks associated with SIBs, bureaucratic processes and general government involvement can put off potential investors. However, it is possible to have a SIB model in which a philanthropist instead of the government acts as commissioner and financial backer.

One of the attractive features of SIBs is its entrepreneurial and innovative nature, where service providers are not constrained by strict government contracts that dictate their every move. Compared to traditional government contracting, SIBs offer a lot more freedom and independence, which could benefit service providers and investors alike.

This works in theory, but in practice, SIBs see a fair bit of bureaucratic involvement and interference. This can occur in the procurement phase, where ministries and departments vet the appropriateness, viability and desirability of service providers and intermediaries.

Most SIBs are commissioned by bureaucracies responsible for signing up to the outcomes they wish to achieve. This narrows the range of potential SIB projects. If the outcomes do not align with the government's broader agenda at the time, then no matter how worthy the project is or how effective it may be, it may not progress.

As they provide financial backing, governments understandably would want to monitor results to avoid any politically embarrassing outcomes. But this could also destroy the very freedom to innovate that makes SIBs attractive. Over-monitoring by bureaucrats could put off private investors and service providers attracted to the flexibility the SIB model theoretically provides.

All this raises the question, does the government need to be involved at all?

Contracts for performance can harness competition and reputation independently of SIBs. However, public sector incentives to design efficient contracts are weak. SIBs can reduce this problem by allowing greater scope for private contracting.

The case for SIBs must be strongest when bringing in private capital offers material net benefits – some combination of philanthropic subsidy, better incentive contracting, better risk management and monitoring, and better accessing of dispersed knowledge and expertise. Passive private risk capital does not provide a net benefit in itself. Instead, it merely redistributes risks and rewards. Government can alter the market risk of the Crown portfolio without recourse to social capital.

But what if a private party, perhaps from the philanthropic sector, took on the government's funding risk? The case is certainly attractive, especially given the anecdotal enthusiasm for SIBs and scepticism about overly bureaucratic procedures. If there were individuals or organisations who strongly supported a SIB project, and were willing to pay back investors their original amount plus a return, then a model without any government involvement is conceivable.

New Zealand private SIBs need not be of the size and scale of overseas SIBs. Projects could be small scale initially. Philanthropists may have had a history of donating to causes and projects they support but not the information and means to hold service providers accountable for outcomes. SIBs can help philanthropists ensure that the causes they support are indeed making a quantifiable difference. Philanthropists could use SIBs to fund and test new ideas to be picked up by the government and brought to scale if proven effective. Finally, the model could serve as a triaging process for philanthropists bombarded with requests for support from a range of social service providers. With this model, philanthropists could choose to fund only those SIBs that have garnered public support.

USING IPREDICT TO TRACK POLITICAL RISK

New Zealand also offers a regulatory environment that can mitigate the political risk inherent in SIBs. What can be done when a policy breaks the basis for contractual payments, for example, by substantially changing baseline conditions for the control group? Futures derivatives markets easily and cheaply traded at Victoria University of Wellington's well-established 'iPredict' might provide the platform for tracking real-time political risk.

Futures markets could help make SIBs more effective in New Zealand. For example, a futures market on the likelihood that investors will get a return at the contracted future date will help all parties monitor an independent record of the likelihood of success as it evolves. The influence of government and other announcements will be recorded in real time. This information could assist in settling any contractual disputes.

THE NEW ZEALAND INITIATIVE

FIVE
CONCLUSION

There is great potential for SIBs to radically change the way some social services are funded and delivered. The focus on outcomes can ensure public and private money is concentrated on what works, and data is collected to hold accountable other government services for outcomes and fiscal costs. The market competition that SIBs encourage also incentivises more effective service delivery and at a competitive cost. This could in turn change the way public services are delivered.

SIBs incentivise innovation and give service providers greater freedom and flexibility to tailor their services depending on feedback. They also foster a close relationship between the service provider, private investor, and service recipient, all of whom have a shared interest in seeing successful outcomes. Rather than separate agencies motivated by very different goals, SIBs bring multiple parties together, all with different backgrounds and expertise, for a shared purpose.

While the concept of SIBs is new to New Zealand, it already fits well with the language and thinking around social enterprise and social entrepreneurship. The rapid growth of these sectors has demonstrated there are many private individuals and organisations in New Zealand with radical and innovative ideas for bringing about social change and who could use SIB models and expertise to put their ideas into action. This level of enthusiasm and expertise is encouraging.

As we have seen from overseas examples, SIBs can be structured in many ways, depending on the political and social environment they are dealing with. Nevertheless, some common themes have arisen so far that can serve as lessons for New Zealand.

There is potential for New Zealand to find uniquely innovative ways of pioneering the viability of the SIB model: a shift in decision-making from individual ministries and departments to an independent office; crowdfunding SIBs and allowing communities to take as much ownership of SIBs as possible; taking the government's role out of the picture entirely; and using iPredict to mitigate political risk.

There is great enthusiasm for the SIB concept, both in New Zealand and overseas. While the model is only in its fledgling pilot stage in New Zealand, a number of private organisations and individuals are seeing this as a good opportunity to bring about social change, while potentially earning a financial return.

However, political risks must be managed. The need is to do so without undue, stifling government interference that quashes the flexibility and innovation that makes SIBs so promising. Government is a major procurer of social services and it is crucial that pilot test cases do not discourage providers, investors and intermediaries from participating in future SIBs involving government procurement.

Governments do not have a monopoly on good ideas when it comes to delivering social services, and other parties could well take the lead in putting good ideas into action. Philanthropists committed to impact investing might consider backing SIBs as a way of demonstrating potential for this mechanism to succeed. While government support for SIBs is important, the private sector can often move more nimbly to demonstrate what can be done.

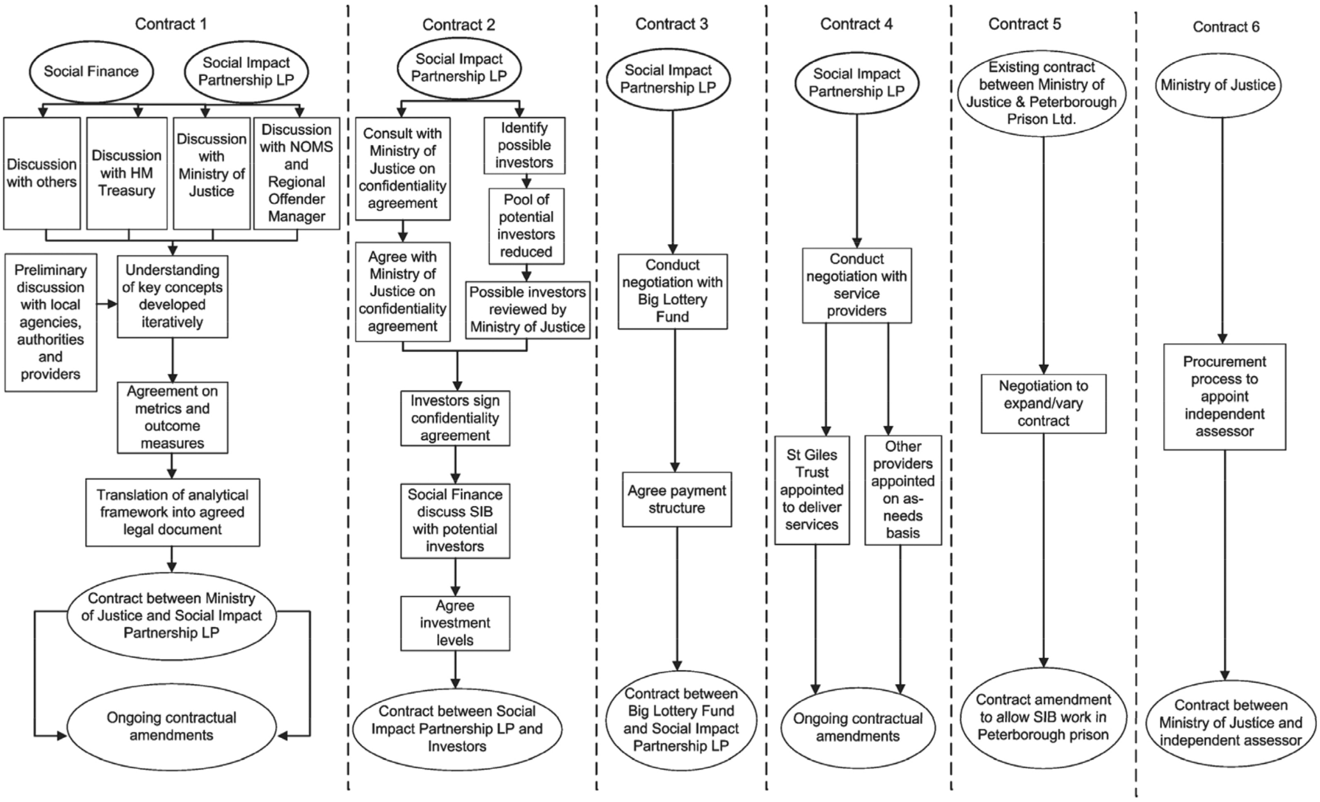
Done the right way, SIBs have the potential to improve accountability for outcomes achieved, build the evidence base for measuring the effectiveness of social services, enhance competition (improving quality and affordability), strengthen community ties through crowdfunding, and most importantly, make a positive and lasting difference to the people government has failed to reach.

THE NEW ZEALAND INITIATIVE

APPENDIX 1

THE COMPLEXITY OF CONTRACTUAL ARRANGEMENTS

Figure 1: The processes of negotiating and drafting contractual arrangements for the SIB



Source: Interviewees' accounts analysed by RAND Europe. Emma Disley, Jennifer Rubin, Emily Scraggs, Nina Burrowes and Deirdre May Culley, "Lessons Learned from the Planning and Early Implementation of the Social Impact Bond at HMP Peterborough," Technical report prepared for the UK Ministry of Justice (Cambridge, UK: RAND Europe, 2011), p. 15.

APPENDIX 2
UK CASE STUDIES

SIB	Investment total	Investors involved	Rate of return	How successful outcomes will be funded
Ministry of Justice: Offenders released from Peterborough Prison	£5 million	Investors and charitable trusts and foundations such as the Barrow Cadbury Trust, Esmée Fairbairn Foundation, Friends Provident Foundation, Panahpur Charitable Trust, and the Tudor Trust tend to have a strong social focus	Payments are capped at £8 million, which would see a rate of return of 13% for investors	Ministry of Justice and the Big Lottery Fund
Department for Work and Pensions	£10 million	Various investment models involved over the 10 distinct SIBs, including single investor, multiple investor, and intermediary models	Variable, based on outcomes achieved	Innovation Fund
Essex County Council: Children at risk of going into care	£3 million	Big Society Capital and Bridges Ventures provided funding to Children's Support Services Ltd, a Special Purpose Vehicle set up to manage the project A separate 'Evolution Fund' has been set aside to provide the flexibility to invest more resources in successful elements of the programme or if more resources than was anticipated are required. The Department for Education, Department of Health, and the Department for Work and Pensions also provided additional funding for set-up costs and evaluation	The total value of outcome payments made over the term of the contract is subject to a cap of £7 million. The SIB could see investors earn an 8% to 12% annual interest on their investment	Essex County Council
Greater London Authority	£2 million	CAF Venturesome, the Orp Foundation, Big Issue Invest, several smaller charitable foundations, and private individuals. The service providers themselves also provide funding	Not specified	Greater London Authority, and funded by the Department for Communities and Local Government

SIB	Investment total	Investors involved	Rate of return	How successful outcomes will be funded
Manchester City Council	To be determined (April 2013)	Details unavailable	The maximum outcome payment that can be made by an individual is £148,600. The scheduling of the outcome payments has been designed to reward longevity and sustained positive engagement with young people: 60% of funding is available during the first 12 months, the remaining 40% can only be earned between 12 months and 3.5 years upon completion of the programme	Manchester City Council
It's All About Me Adoption Bond	£2 million	Private investors and institutional funders	Offers a 4% yield. The bond has been designed specifically to pay a commercial return to break away from the narrower social investment markets into the normal investment market	Local authorities and the Social Outcomes Fund

Source: Centre for Social Impact Bonds, "Case Studies – Existing SIBs" (London: 2013).

APPENDIX 3
AUSTRALIA (NSW) CASE STUDIES

SIB	Investor total	Investors involved	Rate of return	How successful outcomes will be funded
Newpin: Children in out-of-home care	AU$7 million	Private investors pay towards upfront costs of the scheme Unlike most SIBs, the government also provides an upfront payment to cover the costs of the intervention, with the remaining payments dependent on the achievement of outcomes	The minimum interest rate is 5% per annum over the first three years (if the restoration rate reaches 55%), while the maximum interest rate is 15% per annum over the full term. The target is 10% to 12% per annum	Department of Family and Community Services (NSW Government) There is significant capital protection, with investor losses limited to 50% at maturity date. Loss of capital would only occur if restoration rates fall below the counterfactual baseline rate
Benevolent Society	AU$10 million	Australian Ethical Investment and the Westpac Foundation	There are two tranches of investment. P class is less risky, as the principal is repaid on redemption. The interest rate for the class is 0% to 10%, depending on performance In the E class, 100% of the principal is at risk, and the interest rate is 0% to 30%, also based on performance	NSW Government

Sources: KPMG, "Joint Development Phase of the NSW Social Benefit Bonds Trial" (2014); Centre for Social Impact Bonds, "New South Wales Government: Children in Out-of-Home Care" (London: Cabinet Office, 19 April 2013).

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