



Social Impact Bonds

Rethinking finance for social outcomes

August 2009



Social Impact Bonds

In the UK, 40,200¹ adults leave prison each year after serving a custodial sentence of less than 12 months. These prison places cost the tax-payer well over £213 million a year² yet, on release, adults on short sentences receive no formal support to help them to successfully resettle into the community. 73%³ of these offenders go on to reoffend within 2 years of release (92%⁴ for those under the age of 21 years).

Government spending on a range of deep-rooted social issues, including healthcare, adult mental health, and school truancy and exclusion, is similarly focussed on expensive interventions that deal with the consequences of the issue rather than addressing the root causes:

- Of £92 billion health expenditure in England, only 3.7% is spent on preventative interventions;⁵
- Adult mental health costs government £10bn each year in benefit payments alone, while only £2m is spent on mental health promotion activities like promoting self-esteem and coping skills;⁶
- Government spends £650m on truancy and £800m⁷ per annum on school exclusions while only £111m⁸ is spent on preventative initiatives.

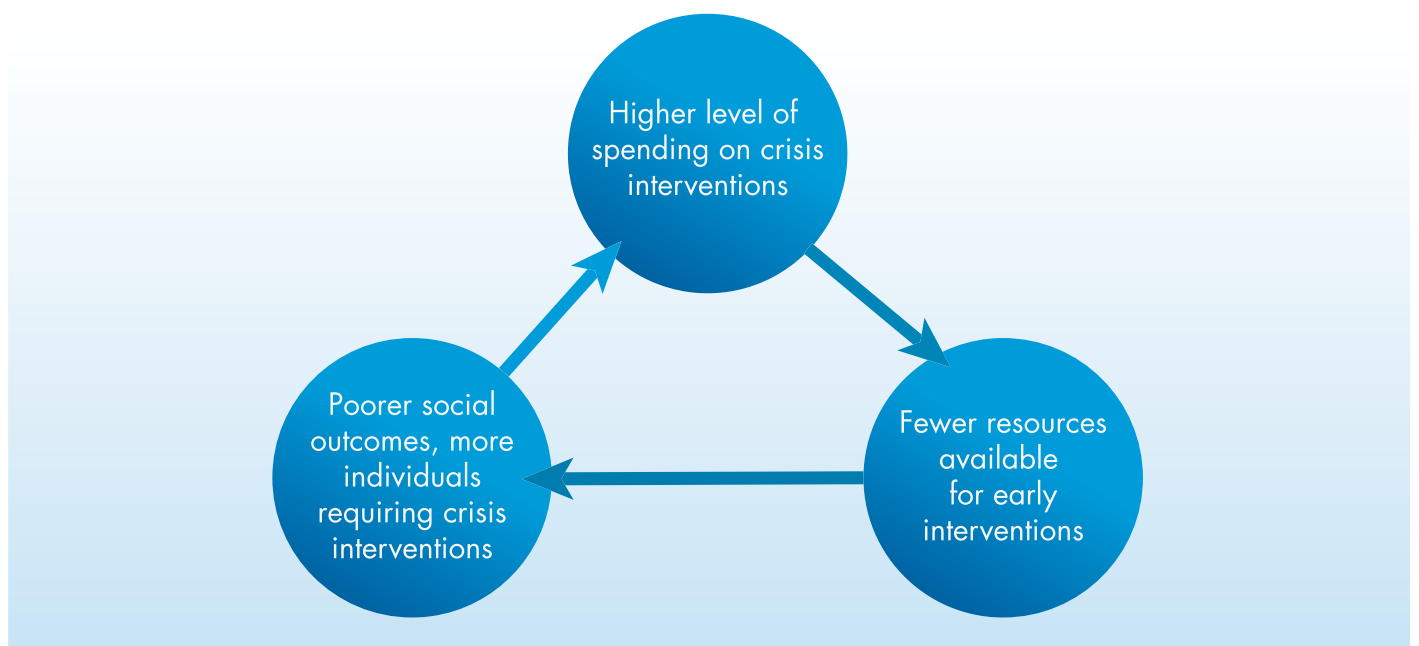
Government budgets are limited and early intervention spending is easier to cut in difficult times. Over time this creates a self-perpetuating pattern of expenditure, resulting in ever worsening social outcomes and an ever growing need for government resources to be spent on expensive crisis interventions (Figure 1).

Historically, charitable trusts and foundations have sought to prevent acute social problems in the UK, using grants to demonstrate and fund interventions that improve social outcomes and reduce the number of individuals requiring crisis interventions. Trust and foundation resources are limited however – only £4.4bn⁹ per year compared to government budgets of £603bn¹⁰ – enabling them to demonstrate effective interventions, but not to make them available to everyone who would benefit. Without reliable, large-scale funding for prevention and early intervention, trusts and foundations are left to fund effective interventions, on a relatively small scale, indefinitely.

In response to this situation, Social Finance has developed a new contracting and financing mechanism: the Social Impact Bond. Social Impact Bonds seek to drive significant non-government investment into addressing the causes of deep-rooted social problems with returns generated from a proportion of the related reduction in spending on acute services. The ambition is to create positive government spending cycles that enable significant tax payer savings through improved social outcomes (Figure 2).

We believe that Social Impact Bonds have the potential to transform the way that a wide range of social outcomes are achieved (Appendix 1). We have been working with a number of government departments to develop a pilot.

Figure 1. **Catch 22:** Negative spending cycle caused by low levels of early intervention expenditure



Social Impact Bond mechanism

Social Impact Bonds are based on a commitment from government to use a proportion of the savings that result from improved social outcomes to reward non-government investors that fund the early intervention activities.

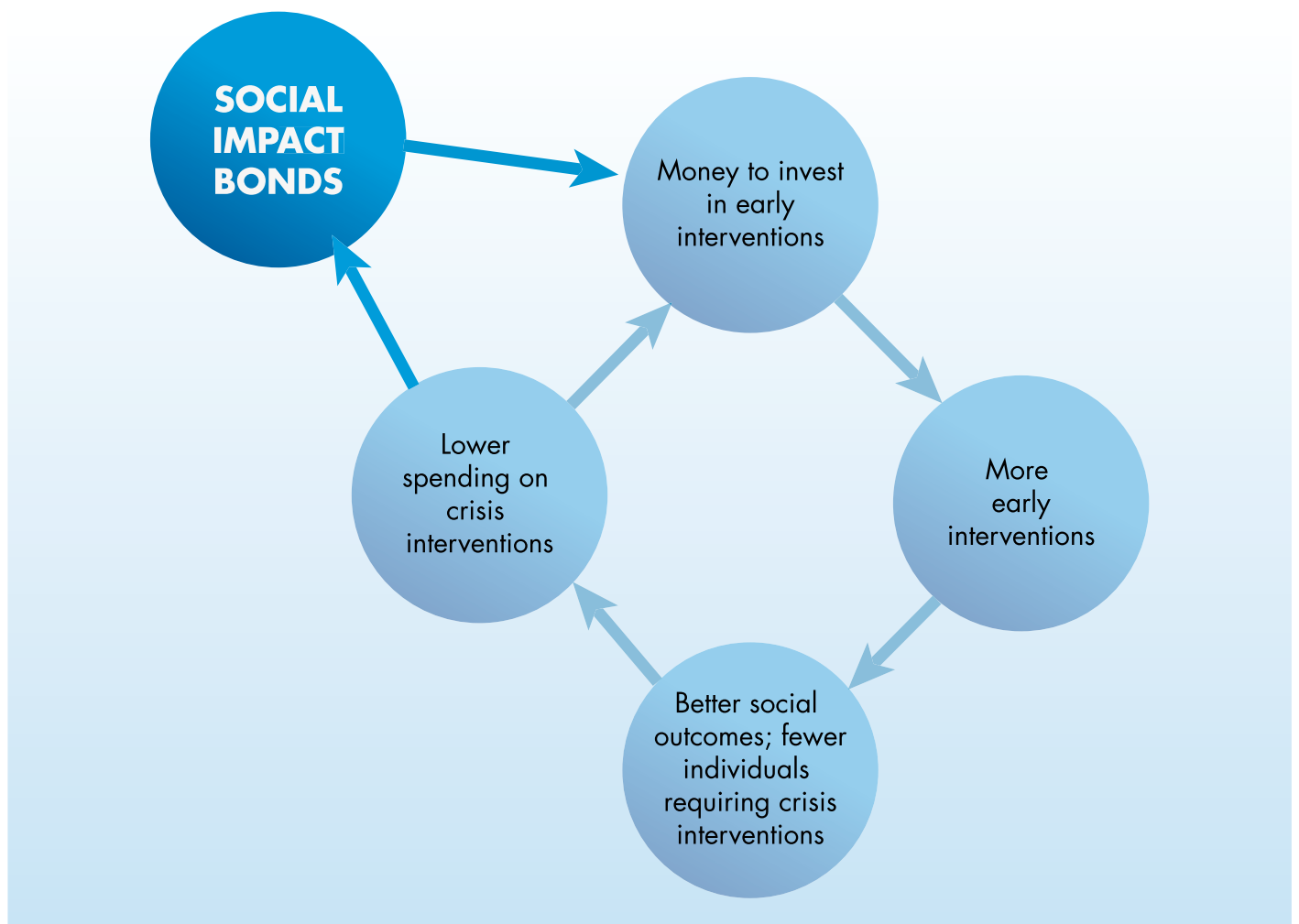
Social Impact Bonds are based on a contract negotiated with government that includes clear definitions of:

- **The success metric** – for example, the 1 year reoffending rate for short-sentence offenders in a specified geographic area;
- **The target population** – for example, offenders aged over 18 leaving prison after a sentence of less than 12 months and returning to a specified geographic area;

- **The value of success** – the amount returned to investors for a given improvement in the social outcome; generally a proportion of the related savings to government. In order to effectively incentivise investors this needs to be tailored to each situation. For example, the value of success may increase as the reoffending rate falls in recognition of the fact that more difficult target groups require more expensive interventions.

Once the contract is in place, investment is raised from non-government investors. This investment is used to finance a range of interventions to improve the target social outcome over the contract period (around 5 years). If the interventions are successful and the social outcomes improve, government pays investors a reward based on the pre-agreed payment schedule.

Figure 2. **Paradigm Shift:** Social Impact Bonds catalyse positive cycles of government spending, improving social outcomes and reducing costs



Aligning stakeholder interests

In addition to catalysing positive cycles of government spending, Social Impact Bonds align the interests of stakeholders around specific social outcomes:

Government

- Social Impact Bonds align government policy priorities with the interests of non-government investors and social service providers;
- Government only pays for improved social outcomes. The risk that particular interventions do not improve social outcomes is transferred to non-government investors.

Charitable trusts and foundations

- Social Impact Bonds create a partnership between trusts and foundations and government that ensures government funding for delivering and scaling-up effective interventions;
- As a broader range of investors become interested in funding demonstrated interventions, Social Impact Bonds offer the potential for trusts and foundations to focus their own funds on developing new solutions.

Social Investors

- Social Impact Bonds create a rational investment market within which effective social service providers receive funding to deliver their services;¹¹
- Social Impact Bonds align the financial and social return on investment.¹²

Social Service Providers

- Social service providers are often excluded by working capital constraints from participation in outcomes-based contracts. Social Impact Bonds enable even small social service providers to participate as the investment raised through the Social Impact Bond funds their delivery costs upfront;
- The outcomes focus of Social Impact Bonds means that funds can be used flexibly to enable effective social service providers to innovate and achieve scale.

Long-term vision

Social Impact Bonds enable foundations, social sector organisations and government to work in new ways and to form new partnerships. By aligning the interests of all parties around common social outcomes, Social Impact Bonds have the potential to address some of society's most intractable problems. While the range of applications for Social Impact Bonds is still being explored, we believe that it is broad enough to enable positive change in four key ways:

- **Unlocking an unprecedented flow of social finance** – investment fund managers believe there would be considerable consumer interest in investing in Social Impact Bonds once a track record has been established and sufficient scale of investment opportunity exists. Ultimately, Social Impact Bonds could become a new social asset class, comparable to microfinance, enabling an unprecedented flow of investment into addressing social issues in the UK and elsewhere.
- **Creating an 'evidence incentive'** – the outcomes focus of Social Impact Bonds makes effective

measurement of social impact more valuable. Within Social Impact Bonds, social sector revenue streams are linked to organisations' social impact creating an incentive to invest in those that are most effective. Developing an evidence base would drive both better practice and research.

- **Creating an 'innovation incentive'** – the outcomes focus of Social Impact Bonds creates an incentive to invest in developing innovative interventions to fill gaps in, or improve upon, existing interventions.
- **Changing the role of government** – government is already commissioning many services in order to address complex and diverse social needs. Social Impact Bonds would enable government to focus on defining social priorities bringing a wider pool of resources and expertise to bear on delivering that change.

Once a track record has been established Social Finance believes that a market of Social Impact Bond investors and fund managers will emerge.

Appendix 1: Potential Social Impact Bond applications

During the development of the Social Impact Bond a range of possible applications have been suggested by potential partners. These include:

Reducing reoffending rates of short sentence offenders

40,200 adults leave prison every year after serving a short sentence.¹³ Over two years, 73%¹⁴ of these prison leavers will reoffend, driving long-term costs to the criminal justice system and placing a burden on a prison system that is operating at capacity.

The West Midlands Region Connect Project delivered a drop in the reoffending rate of 17% for participants over a 2 year period.¹⁵ On this basis, Social Finance estimates that national implementation of a Social Impact Bond to resettle prison leavers could deliver cost savings to government of £900m over 5 years.¹⁶

Reducing the number of young people entering Pupil Referral Units

Each year over 10,000 children are excluded from schools in the UK. On average, a child excluded from school costs the taxpayer an additional £64k¹⁷ over the child's lifetime, driven largely by the increased education costs of a pupil referral unit. School-Home Support, a charity that provides social support in schools in London, Yorkshire and the Humber, has demonstrated the ability to reduce exclusions by 25% at a cost of £29k per prevented exclusion generating a net saving to society per student of £35k.

A 25% reduction in the number of excluded children nationally would generate an annual saving to tax payers of £90m. A Social Impact Bond could be

structured to raise funding for interventions focussed on reducing the number of exclusions.

Reducing the need for residential placements for children in care

England has around 60,000 looked-after children of which 14% are in residential care.¹⁸ Foster parents can struggle under the pressures of care which leads to family breakdowns and children being taken into full-time residential care. The average cost of looking after a child in foster care is £489 per week, while residential care costs five times as much at £2,428 per week.¹⁹

Interventions focussed on supporting foster carers, such as respite foster care schemes which provide a break for both parent and child, and intensive multi-agency support programmes for foster carers, can reduce the long-term costs and create more positive outcomes for looked-after children. A Social Impact Bond could be introduced to fund such interventions.

Reducing acute hospital spend through the increased provision of community-based care

In the UK around 3% of over 65s are responsible for 35% of unplanned hospital admissions; 75% of this group live in private homes.²⁰ Each unplanned admission is estimated to cost £6,500.²¹

A Social Impact Bond to fund interventions to reduce this admission rate could save money for Primary Care Trusts and improve health and quality of life for the elderly. The Evercare community care model, for example, has reduced hospital admissions by 50%.²²



Appendix 2: Comparison with outcomes-based commissioning

In these budget-constrained times, the major political parties in the UK are seeking to move further towards outcomes-based contracts for social services. Outcomes-based commissioning moves beyond a focus on the outputs of a particular intervention (e.g. the number of people attending a training course or provided with home-based care), to focus instead on the desired outcome from those interventions (e.g. the number of people finding and keeping a job, or a reduction in acute hospital admissions). Outcomes-based commissioning is attractive to government as it means that it only pays for success while the risk

and associated costs of unsuccessful interventions are borne by a third party, generally the service provider. In reality, however, current approaches to funding public service outcomes are sub-optimal and have struggled to reach scale.

This section looks at how Social Impact Bonds address some of the limitations of current outcomes-based commissioning.

Outcomes-based commissioning

Poor access to working capital

Service providers, particularly those in the third sector, often lack financial reserves and cannot access the working capital from banks or investors that they would need to work within a framework in which they are paid in arrears on a contingent basis.

Social Impact Bonds

Service provider costs are covered by investors upfront

Social Impact Bonds are used to raise a fund to address a clearly defined social need in a specified geographic area (e.g. reducing reoffending rates in the West Midlands). Throughout the duration of the contract (around 5 years) proceeds are used to fund a range of interventions that address the target outcome. In this way Social Impact Bonds transfer the risk that an intervention achieves an improvement in the target outcome away from service providers to investors. This risk transfer should enable even small third sector providers, that would otherwise be excluded, to participate in outcomes-based contracting. Furthermore, by providing revenue to effective service providers, Social Impact Bonds should foster greater competition and innovation driving improvements in both the effectiveness of interventions and the cost of service provision.

Payment schedules create perverse incentives

Currently, outcomes-based payment schedules tend to be binary – i.e. success is rewarded when a specified outcome threshold is reached, but not above or below this threshold. Alternatively, service providers are rewarded for each incremental improvement in the target outcome, but at a fixed rate – i.e. the reward payments do not take into account the increasing marginal cost (and benefit) of each subsequent improvement in the target outcome. As a result, service providers are incentivised to ‘cherry-pick’ the easiest individuals within the target group and, in the case of binary payment, to stop providing the intervention once the payment threshold has been reached.

Outcome payments are proportionate to success

Outcome payments are made annually in arrears in proportion to the outcomes achieved according to a pre-agreed metric of success (e.g. the proportion of prison leavers that reoffend within 12 months of release). The value of the outcome payments, linked to the corresponding cost savings to Government, is agreed at the beginning of the contract period. To disincentivise ‘cherry picking’ of the easiest to work with individuals from the target population, outcome payments may increase with successive percentage point improvements in the target outcome in recognition of the increasing marginal cost (and benefit) of each incremental improvement.

Contracts tend to be made with single providers

In contrast to commissioning for outputs, where a single provider can commit to providing a specified number of outputs (e.g. training course places or hours of home-based care), the complex nature of many social problems, means that it is rare that a single service provider can provide an intervention that, alone, achieves significant improvements in a given outcome (e.g. employment rates or acute hospital admissions). Outcome-based contracts with single providers implicitly assume a 'one size fits all' solution and are therefore plagued by a high likelihood of over-attribution of impact to a single intervention. This also creates an absence of incentives for other statutory and non-statutory service providers that interact with the contracted provider to achieve the target outcome, and a tendency for commissioners to over-specify the means by which the outcomes are achieved. This is very likely to restrict the potential for such contracts to significantly improve outcomes for communities given the widely recognised value of flexibility and innovation in effectively addressing social problems, especially in contexts of economic and demographic flux.

Investment will fund a portfolio of interventions

In recognition of the fact that most social and community needs are complex, and rarely is there a 'one size fits all' solution, Social Impact Bond investment will fund a flexible portfolio of locally-tailored interventions that address the target outcome. Social Impact Bond funded interventions will be coordinated and aligned with existing provision in order to leverage maximum social change. This will be facilitated through local partnership councils that include representatives from a broad range of local service providers, the voluntary sector and the local community.

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Endnotes

- 1 *Offender Management Caseload Statistics* (Ministry of Justice, 2007).
- 2 Estimate based on total Prison Service operating budget of £1,936m for 2006/7 multiplied by 11% (proportion of prison population who are short-sentence offenders). *Breaking the Cycle* (New Philanthropy Capital, 2009), *Unlocking Value* (NEF, 2008). Estimate does not include other costs associated with offending such as police and victim costs.
- 3 2 year re-offending rate. *Reoffending of adults: results from the 2004 cohort* (Home Office: 2006/07).
- 4 *Reducing Re-offending by Ex-prisoners* (Social Exclusion Unit, July 2002).
- 5 *Prevention & Preventative Spending* (Health England, 2009).
- 6 *Don't mind me: adult mental health problems* (New Philanthropy Capital, 2006).
- 7 Cost of truancy £650m per year and cost of school exclusions £800m per year. *Misspent Youth* (New Philanthropy Capital, June 2007).
- 8 Annual average based on DFES spending of £885m between 1997–2004. *Improving school attendance in England* (National Audit Office, February 2005).
- 9 *The UK Civil Society Almanac 2009* (NCVO, 2009).
- 10 *Public Expenditure Statistical Analysis 2000* (Office of National Statistics, 2009).
- 11 This contrasts with the majority of current government contracts which tend to be based on cost per output (e.g. the number of offenders worked with) rather than outcome-based measures (e.g. reductions in reoffending rates) making rational social investment decisions difficult. A detailed comparison of Social Impact Bonds with outcomes-based commissioning can be found in Appendix 2.
- 12 The financial returns for Social Impact Bond investors increase with improving social outcomes.
- 13 See note 1.
- 14 See note 3.
- 15 The West Midlands Region Connect Project.
- 16 Social Finance analysis based on 40,200 short-sentence prison leavers, average cost per re-offender over 5 years of ~£75,000 and decline in re-offending by 17% over 5 years for participants.
- 17 *Misspent Youth: The costs of truancy and exclusion* (New Philanthropy Capital, June 2007)
- 18 *Looked-after Children Vol 1* (House of Commons report, March 2009).
- 19 See note 18.
- 20 Evercare is a US company now operating in the UK with a number of Primary Care Trusts, it has reduced hospital admissions in the US by around 50% – *Implementing the Evercare Programme: Interim Report*.
<http://www.library.nhs.uk/healthmanagement/viewresource.aspx?resID=263705> (accessed 17 August 2009)
- 21 Assuming an average cost of £500 per night and an average stay of 13 nights. Cost per night taken from *My cancer cure, a month in a hotel* (Sunday Times – 20/11/05). Average stay taken from Age Concern:
<http://www.ageconcern.org.uk/AgeConcern/4ADE398DB5884555B8C872D37BF8F9C.asp> (accessed 17 August 2009)
- 22 See note 20.

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Social impact through effective finance

Social Finance brings together social and financial expertise to enable more, more effective and more reliable funding for social impact.

We support social investors and social sector organisations to explore their financing options, working with them to create solutions that enable them to achieve their aims.

Our advisory and capital-raising services are supported and informed by our research and market intelligence. We seek to accelerate the development of the social investment marketplace in the UK through innovation and management rigour.

To find out more about Social Impact Bonds contact Toby Eccles, Emily Bolton or Louise Savell at Social Finance on: 020 7182 7878 or at info@socialfinance.org.uk

Social Finance Ltd
42 Portland Place
London. W1B 1NB
t: +44 (0) 20 7182 7878
f: +44 (0) 20 7182 7879
e: info@socialfinance.org.uk

www.socialfinance.org.uk

