

Social impact bonds

Private finance that generates social returns

SUMMARY

Social impact bonds are a results-based form of social impact investment. Private investors provide capital to launch or expand innovative social services that provide a public good. If the expected social benefits are achieved at the end of a given period, investors receive back their capital plus a rate of return (negotiated with public authorities and varying with the level of results achieved). Social impact bonds are increasingly common in the United Kingdom, as well as in the United States and Australia, and have begun to be used in a number of other EU Member States.

Social impact bonds have the potential to tap large capital markets so as to launch new social services. Private investors can earn attractive investment returns for assuming the risks associated with the service. Social enterprises can benefit from the business experience of investors, and the interests of all partners may be better aligned from a strict results-oriented approach. Public authorities do not need to stump up capital to launch a new service and do not need to shoulder the risk if the intervention is not successful. On the other hand, designing services where results can be accurately measured is not easy and more experience is needed before investors have a clear idea of risks and returns in this new asset class.

The European Commission has promised to facilitate the exchange of experiences between Member States with social impact bonds. The European Parliament has called for greater use of innovative financing for social benefit and for more specific proposals from the European Commission.



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Background

Since the onset of the financial and economic crisis, many countries have been trying to reduce government deficits and public debt. Pressure on government spending has meant that in many cases social interventions are underfunded, including services designed to alleviate the suffering that the crisis and subsequent recessions have caused. As a result, there is a need to find new innovative financing and delivery mechanisms for social services.

Applying financial innovation to social goals is not a new idea. Microfinance, which now represents a US\$65 billion market worldwide, has shown how bundling together very small loans to many borrowers can realise significant social and economic benefits, while mobilising additional credit and providing a solid financial return to investors. In a similar way, some governments have been looking at social impact investing as a way to tap into new sources of funding for social programmes and a means to ensure that scarce public resources are used in the most efficient and effective way possible. In particular, much attention has been devoted to social impact bonds, an investment vehicle that makes use of private capital to achieve social goals.

Up until now most social finance and most social impact bonds have been created in English-speaking countries, particularly the USA, Australia and the UK, but the idea is beginning to be applied in other EU Member States including the Netherlands, France and Germany. Social impact investment, and social impact bonds in particular, have the potential to expand rapidly over the next five to ten years. According to [one consultancy](#), if just 5% of retail investments in UK Individual Savings Accounts (ISAs), 0.5% of institutionally managed assets and 5% of charity investment assets were dedicated to social investment, more than £10 billion would be available to finance new social projects in the UK.

What is social impact investment?

Social investment has been used to describe a way of thinking about social spending in Europe since the adoption of the Lisbon Agenda in 2000. It is based on the premise that public social spending today will pay off at some point in the future through greater economic growth and employment. For example, better early childhood education may result, in the future, in a more effective and competitive workforce that pays more in taxes and receives less in unemployment insurance and welfare payments. Applying this principle helps to prioritise those types of public welfare spending that have the greatest beneficial effects.

On the other hand, **social impact investment** (sometimes referred to as 'social enterprise financing' or 'social finance' but also – confusingly – sometimes called simply 'social investment') is the use of private investment capital to finance activities that generate a social benefit as well as a financial return. Social impact investment typically differs from more traditional types of investment in providing greater flexibility in repayment terms, lower interest rates, and the acceptance of greater risk than commercial lenders would normally consider. However it remains an investment: the expectation is that the original funds supplied will be recouped by the investor with an additional return on capital.

While the market for social investment in the UK was estimated to be only just over £200 million in 2013 (a figure dwarfed by the almost £15 billion of voluntary donations

to charities in the fiscal year 2010/11), it is [expected](#) to grow rapidly to reach £1 billion by 2016. The potential is even larger if charitable organisations divert even a [small part](#) of their foundation capital to social impact investment rather than investing for profit in traditional equity or bonds and using the income to provide non-repayable grants.

Social impact investment can be used by social enterprises or charities to purchase assets like buildings or property; to provide working capital; to expand existing social services; or to provide funding to develop entirely new services. The [type of investment](#) also will determine the way in which revenue will be generated to repay the loan and the subsequent return. Revenue can come from expanded sales of goods (e.g. a charity shop), from specific services (e.g. fees from training courses for child services specialists), fees earned from local authorities by providing a social service, or future grants and donations anticipated following the opening of a new centre.

Another option is to enter into a 'payment by results' contract with a government authority. The service provider proposes a service that is expected to produce a favourable social result. For example, a third-sector organisation could propose training and support services to help underprivileged young people find work. The social result (increased employment among those young people) reduces future government spending and the government splits the savings with the service provider. The best known form of a 'payment by results' contract is a [social impact bond](#).

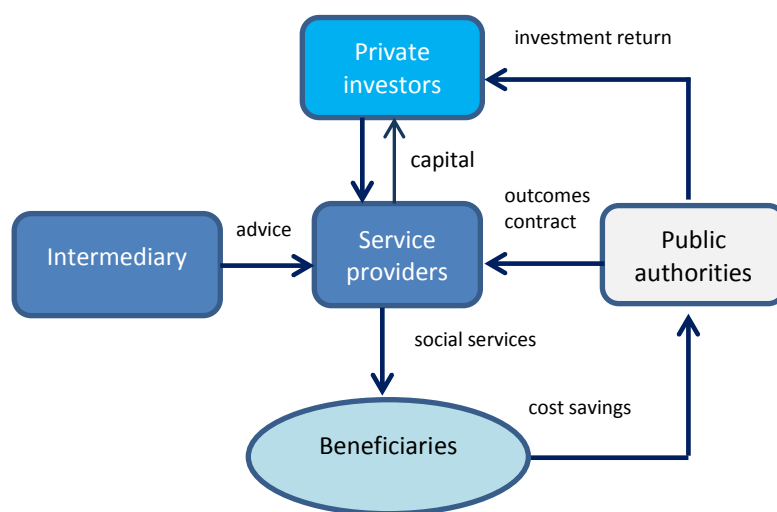
And social impact bonds?

Arguably the best known form of social impact investment, social impact bonds¹ are multi-stakeholder arrangements between a public authority, investors, a service provider and an intermediary organisation. A bond is sold to private investors who are paid a return only if the associated social project succeeds in attaining a certain level of social result within a given period of time.

More specifically, capital provided by *private investors* is used by one or more *service providers* to set up or finance activities that will both bring about positive social outcomes for the beneficiaries and reduce future public costs. These cost savings are then shared by *public authorities* (sometimes referred to as the *commissioner* of the bond) with the original investors, who receive payment in the form of a return on their original capital investment. Usually an *intermediary* or *advisor* brings together these three players

and helps to set up the necessary structures in return for a fee. In principle, both the investors and the public benefit from this 'win-win situation'. Best of all, no public funds need to be raised or committed² during the set-up and operation of the service, i.e. until the desired results are achieved.

Figure 1: Relationships between partners in social impact bonds



Adapted from: [The Future for Children bond](#) / A. Rotheroe, I. Joy, P. Lomax, Allia, 2013; [Payer pour obtenir des résultats](#): résoudre les questions complexes de notre société grâce aux obligations à impact social / Deloitte (Canada), [n.d.]; [Private finance for public goods: social impact bonds](#) / M. Warner, 2013.

Social impact bonds are a form of 'pay for results' funding because the repayment of the original investment and/or payment of financial return is dependent on the achievement of measurable social outcomes. If the service attains a certain goal (i.e. social outcomes improve), then at the end of the term of the bond, the original investment is repaid to the investors plus a financial return. This return may vary depending on the extent of the improved outcomes, with higher returns paid for better results.

As is evident from this description, the name 'bond' is in fact a misnomer: social impact bonds are not like traditional bonds, i.e. debt securities that pay out a fixed rate of interest until maturity. They are more like equity investments that pay out only on the basis of results achieved, and they carry high levels of risk: social investment bond-holders may lose their entire investment if the project is not successful.

Creating a social investment bond [involves](#) choosing a social issue, developing an intervention strategy, setting a budget and establishing outcome measurements (including controls), as well as a financial framework (including a time frame and rates of return). Once the bond is set up, investors have to be found. Typically investors in social impact bonds include those interested in more than just a financial return, such as [philanthropists and grant-making trusts](#), who are prepared to accept a lower financial return or greater risk in order to generate a social benefit.

Social enterprises do not have to rely entirely on social impact bonds, but may use social impact bonds as part of blended financing. Some [experts](#) give the example of a social enterprise that can earn a return of 5% on a new health clinic costing £100 000. If a charitable foundation were to donate

£50 000 towards the initial capital needed to set up the service, the return on a loan of £50 000 to make up the difference could be 10%, sufficient to find funding on the credit market. The health clinic would bring benefits to the people served, the charitable foundation would not need to finance the whole cost of the clinic (or could use £50 000 from its remaining funds for another project), and the private creditors would earn a reasonable return, so that all participants would benefit. Alternatively, the charitable foundation could guarantee a loan for the full £100 000, bringing down the risks and hence reducing the cost of the full loan obtained on the open market to a reasonable 5% level. (The Bill and Melinda Gates Foundation has provided such loan guarantees rather than grants for a number of projects that it supports). In either case, donors are able to leverage their gifts with private capital so as to support more activities; social

The pilot project at Peterborough Prison (UK)

What has been described as the [world's first social impact bond](#) has been used since 2010 to [finance rehabilitation work](#) at Peterborough Prison in the UK. Organisations as well as individuals are investing £5 million to pay a range of 'third sector organisations' to prepare rehabilitation programmes and help approximately 3 000 male prisoners serving sentences of less than 12 months. Previously there was no such programme for these short-term prisoners.

If, after six years, the One Service (as it is called) is successful in reducing re-offending by more than 7.5%, investors will receive their investment back, plus a return based on the proportion of the cost of re-offending. Total payment will be capped at £8 million. If the intervention is not successful, investors receive nothing. Payments of the investment return will be made out of savings in the cost of prosecuting and jailing re-offenders. The programme has been supported by both the current Coalition government in the UK and its Labour predecessor.

[Preliminary results](#) suggest that reconviction rates at Peterborough have fallen by 11%, compared to a 10% increase nationally; final results based on the methodology used to evaluate the success of the bond will not be available until late 2014.

enterprises have access to more capital and more opportunities to create social value; and investors have new investment opportunities.

Benefits

Social impact bonds increase the pool of capital available for social interventions by tapping into private finance, but that is not the only benefit they may bring. Proponents of social impact bonds suggest that involving investors who are knowledgeable and experienced in business brings new rigour and discipline to the supply of social services. Private-sector financial organisations are also considered by some to be better at identifying good risks than many third-sector organisations and private companies are thought to be more innovative and responsive than public-sector services. The focus on results is also considered to help with alignment of objectives between different partners in social interventions including the service providers. Charities can become more effective by using investment to scale up their services, to develop new projects or to smooth out uneven cash flow.

There are three main advantages for a public authority: no funding or capital has to be found to invest in setting up such social interventions; the risk of failure is transferred from public authorities to private investors; and no additional funds are needed to pay the return, since if the goal is met, public savings generated by the social result will be greater than the promised investment return. For example, the public cost of a homeless person in the UK is about [£8 000](#) per year, which represents more than £30 million over five years for a group of more than 800 chronically homeless people in London. A [social impact bond](#) targeting this group (commissioned by the UK Department for Communities and Local Government and the Greater London Authority) will pay out a maximum of £5 million to investors if optimal outcomes are achieved. But even in this case there will be considerable savings in direct costs as well as reduced public expenses related to crime, health services and unemployment benefits.

For investors, social impact investments are expected, over the long term, to provide rates of return equivalent to the market rate of other investments with similar levels of risk, e.g. equity investments. However they also constitute a completely new asset class of investment, allowing investors to diversify portfolios with investments that should have little correlation with equity and bond markets. Some investors may of course also wish to be seen to be doing good for society, and so burnish their reputations. At this early stage of development, others (such as financial institutions) may make modest investments in part to learn more about this innovative financial sector. Furthermore in a period when many grant-making trusts and foundations are seeing much lower returns from their conventional investments (and hence reducing the amount that they can give in grants), social impact investing may provide them with higher returns as well as making their capital work directly for the social good.

A social investment bank

[Big Society Capital](#) (BSC, originally Big Society Bank), the world's first social investment bank, was launched with UK government assistance in 2012. The initial funding came from money held in dormant bank and building society accounts (expected eventually to reach [£400 million](#)), topped up by £50 million in investments from four major UK banks. The BSC acts like an investment bank, investing in social finance intermediaries with the aim of creating a social investment market. [Investments](#) to date include social bonds to support the adoption of 'hard-to-place' youngsters and an intervention programme for vulnerable young teenagers, as well as a social impact bond fund providing financing to social organisations wanting to undertake payment-by-results projects.

Challenges

Social impact bonds are not a panacea, however, and their development presents certain challenges. Arguably the most critical difficulty is the selection of a social activity or service that produces a measurable outcome which can be clearly attributed to the service. Fundamentally, the measurement of social outcomes is a complex task. Underestimating or misunderstanding the complex interactions and conditions involved in social problems can lead to simplistic conclusions about cause and effect. For example, the recidivism rate in released prisoners may be affected by a new counselling service supported by a social impact bond but it might also be dependent on unrelated changes in housing, social security benefits or the local employment market. A measurable reduction in the numbers of repeat offenders might not be due to the new service but to improvement in these other areas, just as failure to reach the goal might be due to worsening conditions in one or more of these aspects. To establish that changes are the result of the new service, a control group can be established, but this is frequently difficult to do, and can give rise to complaints of discrimination from those in the control group who of course will not benefit from the new intervention. The Global Impact Investing Network's Impact Reporting and Investment Standards project ([IRIS](#)) seeks to establish a framework and criteria for reporting on social outcomes.

There are also specific challenges for social enterprises, charities or community-interest groups which are strongly mission-driven. They may have [difficulty](#) with the business-driven aspects of social finance and lack the necessary financial expertise, or they may feel that providing a return on investment is ethically incompatible with social work. Charities in particular may feel that social investment organisations are a competitive threat, in that increasing social impact investment could lead to a reduction in charitable grants. According to [some experts](#), the need for social purpose organisations to evaluate the social impact of their actions may interfere with their operations and values, and the control that those evaluations impose may interfere with their independence.

Performance-based services may also result in distorted activity: in order to meet targets, service providers may be tempted to ignore or 'park' clients who are difficult or expensive to help and 'cream' clients who are easier to assist or who are more likely to be successful in the terms of the project. At least in the UK, the majority of social

Private investment funds

[Bridges Ventures](#) is a British private investment firm founded in 2002 that aims to achieve social or environmental goals as well as financial returns. With £340 million currently under management, their [investments](#) include four social impact bonds: one programme in the area of child support services (running 2013-18) and three for disadvantaged young people (2012-15).

In 2011 [Deutsche Bank](#) launched an Impact Investment Fund with £10 million, to provide finance over three years to intermediaries investing in social enterprises. It has [invested](#) in Bridges Ventures as well as Impact Ventures UK (a total of £20 million raised for disadvantaged people and communities in the UK) and Social Venture Fund II (£16 million raised in total). The latter's predecessor, Social Venture Fund I, invested in European organisations helping people with autism, facilitating micro-donations and aiding the hearing-impaired.

In April 2014, the French insurance and investment group [Axa](#) announced a €150 million fund, Impact Investment Initiative, to invest in private equity, microfinance and social impact funds. It is expecting returns of [between 4% and 8%](#), depending on the trade-offs between social and financial benefits.

enterprises are small, designed to address local needs, and lack the capacity to make efficient use of the large amounts of capital that social impact bonds could provide.

There are also financial and investment challenges associated with social impact bonds. In general, there is a [lack of knowledge](#) about social finance on the part of investors and their advisors, and confusion about the definition and nature of different kinds of social investments, which makes attracting retail investors difficult and which increases [marketing costs](#). In a 2011 JPMorgan Chase [survey](#), investors expressed concerns that social impact bonds are relatively illiquid investments that tie up money for a comparatively long period of time (e.g. eight years for one UK [social enterprise](#)), and that anticipating both financial and social returns is difficult, in part because of a lack of historical precedents and of hard data. Social investments may generate a lower financial return than conventional investments with the same risk (though of course for some investors this is offset in part by the social returns).

In general, there is a [lack of transparency](#) and regulatory clarity in terms of this new type of investment. Development of a real market in social impact investments may require regulation in order to prevent collusion between intermediaries, service providers and those who evaluate the social result. In addition, gains from traditional equity or fixed income investments are often tax-exempt if given as a charitable donation, but a lower return from a socially beneficial investment is taxed at the full rate. [Some experts](#) have called for both a new regulatory framework and tax relief for individual investors to encourage them to invest in the social finance sector rather than traditional equity markets. In July 2014, the UK Parliament [adopted](#) legislation that introduced [tax relief](#) for social impact investments.

Netherlands

In December 2013, the municipality of Rotterdam signed a [social impact bond](#) worth €680 000 with investors ABN Amro and Start Foundation and provider Buzzinezzclub. Investors will be paid returns up to 12% per year if Buzzinezzclub is successful in helping 160 unemployed young people without basic qualifications to find work or go back to school.

The EU context

In the EU, social policy remains the responsibility of Member States, with the role of the EU largely confined to coordination and exchange of best practice. In February 2013, the Commission published a '[Social investment](#)' communication that recognised the need for social enterprises to access private finance. To stimulate such funding, the Commission emphasised microfinance initiatives and a proposed European label for social entrepreneurship funds. The Communication also promised to facilitate exchanges between Member States of experiences with social impact bonds.

In its [response](#) to the Communication, the European Parliament (EP) reiterated that the public sector was not the sole source of resources for social policies. The EP called on Member States to make more use of financial engineering through instruments such as social impact bonds, and asked the Commission to make more detailed proposals on new financial instruments that could leverage public social investments.

In May 2013 the European Investment Fund (EIF), which helps micro-, small and medium-sized enterprises access finance, launched the [Social Impact Accelerator](#) (SIA), a pan-European public-private partnership for social impact investing. This initiative was described as a response to the EU policy goal of establishing a dedicated instrument to support social inclusion in Europe. (The EIF had earlier made [investments](#) in one of the

Bridges Ventures funds, see box above). The SIA will provide initial equity financing of €60 million to investment funds that target social enterprises across Europe, in part with the aim of encouraging the long-term sustainability of the social investment sector. Its first [investment](#), in late 2013, was in the Social Venture Fund, a German social venture capital fund with more than €16 million in funding.

Further reading

[Private finance for public goods: social impact bonds](#) / M. Warner, Journal of Economic Policy Reform, v. 16, No 4 (2013), p. 303-319.

[Social impact bonds: a wolf in sheep's clothing?](#) / N. McHugh et al., Journal of Poverty Research, v. 21, No 3 (2013), p. 247-257.

[Social impact bonds: opportunities and challenges for the Netherlands](#) / B. Vennema et al., ABN-Amro, 2013.

[Shining armour or sheep's clothing: views on social investment in the UK](#) / M. Duffy, Clore Social Leadership, [2013].

[A new approach to funding social enterprises: unbundling societal benefits and financial returns can dramatically increase investment](#) / A. Bugg-Levine, B. Kogut, N. Kulatilaka, Harvard Business Review, v. 90 n. 1-2, 2012, p. 118-123.

[Social impact investment: the challenge and opportunity of social impact bonds](#) / G. Mulgan et al., Young Foundation, 2011. (revised edition).

[Centre for social impact bonds](#) / UK Cabinet Office. (Web site)

Endnotes

¹ Social impact bonds used in development cooperation are referred to as [development impact bonds](#) but the basic principles are the same.

² A government may choose to *forego revenue* before results are achieved, e.g. by providing income tax relief for social impact investments before the investment generates a return.

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eprs@ep.europa.eu

<http://www.eprs.ep.parl.union.eu> (intranet)

<http://www.europarl.europa.eu/thinktank> (internet)

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