Advancing Social Impact Measurement to Build an Asset Class:

The Appeal of Social Impact Bonds

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Financial metrics have long been utilized to assess investment performance. Social impact measurement, on the other hand, has lacked the same kind of history and rigor. Until recently, social impact has often been anecdotal, rather than quantified using specific metrics. Where social impact has been tracked, investors have lacked access to common metrics. As a result, information on social impact has been fragmented, making it difficult to compare investments of similar social aims. The lack of standard measures has also placed a burden on organizations that have to report on a wide variety of metrics to satisfy their investors. The absence of a coordinated language has imposed high costs on both investors and organizations.

However, investors may soon have an opportunity to invest in a unique instrument that has been creating considerable buzz in the impact investing community over the past year. Social Impact Bonds (SIBs), which raise private capital to pay for evidence-based prevention programs that create government savings, reward investors as the funded interventions create better social outcomes. Rather than funding good intentions, investors in SIBs know they are creating real societal benefit; investors' financial returns are linked to measurable social impact. SIBs reflect an important movement in the impact investing sector toward robust measurement of social progress. Credible and reliable measurement of social impact is essential if impact investing is to attract investors at scale and become a large, sustained asset class. This article explores the potential of SIBs to advance social impact measurement and attract new sources of funding for critical community development services.

A New Asset Class

SIBs are unique public-private-nonprofit partnerships that align the interests of nonprofit service providers, investors, and governments in an effort to improve the lives of individuals and communities in need. Investors provide upfront working capital to nonprofit organizations to implement proven preventative programs. These programs aim to achieve specific and measurable social outcomes that generate government savings. If an independent evaluator determines that the pre-defined outcomes have been met, the government repays investors their principal and a rate of return that accounts for a share of its savings. If the pre-defined outcomes have not been met, the government owes nothing.

Following Ben Franklin's maxim that "an ounce of prevention is worth a pound of cure," SIBs fund effective programs that tackle the root causes of homelessness, crime, and other disabling economic and social conditions. If SIBs succeed, all partnership stakeholders would benefit. The government would be able to transfer the risk of funding prevention programs to the private sector. Since it only repays investors if the SIB-funded interventions produce cost savings over and above the cost of the intervention, the government would gain accountability for taxpayer funds and better results for its citizens at lower public expense. High-performing nonprofit service providers would have unprecedented access to growth capital to expand their operations. This access to the capital markets would impose market discipline on nonprofit service providers, which would increase competition and result in more effective programs with better outcomes. Furthermore, the stable and predictable revenue stream from SIBs would allow them to spend less time fundraising and more time focusing on serving populations in need. Most importantly, the wider availability of effective prevention services would benefit vulnerable individuals, families, and communities, and break their reliance on crisis-driven interventions.

For investors, SIBs provide a new way to achieve both social impact and financial return. Unlike existing impact investing products, SIBs provide returns that are commensurate with social benefits: the fewer at-risk youth who reoffend, for instance, the higher the financial return. SIBs convert social interventions into investable assets by monetizing social outcomes, or calculating the public-sector cost savings associated with the outcomes produced as a result of the intervention. This unique feature allows investors to fund solutions to social problems in a way that had not been available to them ever before. For example, SIBs turn an intervention to end homelessness into an investable opportunity, where it was once the distinct territory of philanthropy and government funding.

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How Social Impact Bonds Incorporate Social Impact Measurement

Measuring impact is at the core of the Social Impact Bond's mechanics. It plays a role throughout the life of a SIB, from selection of the intervention to investor repayment. When selecting potential SIB-funded interventions, for instance, intermediary organizations that structure SIBs require strong evidence that the interventions will lead to better outcomes for a target population. They rely on existing studies that have measured statistically significant social outcomes. Once an intervention is selected for SIB funding, intermediaries identify social metrics to measure over the course of the instrument that indicate the intervention's progress in improving lives and from which governmental cost savings can be calculated. Finally, the achievement of those metrics triggers investor repayment.

The first and only SIB in the world demonstrates the mechanics of the instrument. Launched in 2010 in the UK by London-based Social Finance, Ltd., the Peterborough SIB raised £5 million (~US$8 million) to fund a comprehensive reentry program for short-sentenced prisoners leaving Peterborough prison over a six-year period. These prisoners typically receive little support upon release; they often leave with little money in their pocket and no housing, job, or family support. Consequently, over 60 percent become repeat offenders within one year. The SIB-funded program aims to facilitate offenders' reentry into the community through efforts to help them find housing, access health care, and increase their income. A government agency, the Ministry of Justice, along with a philanthropic partner, the Big Lottery Fund, agreed to repay SIB investors if one-year post-release reconvictions decrease by at least 7.5 percent, relative to a comparison group. If reconvictions do not decrease by this amount, investors lose their principal. If the program successfully lowers reconvictions beyond this benchmark, investors will receive returns that range between 2.5 percent and 13 percent, with larger returns for better social outcomes.

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As SIBs are best suited to scaling what works, interventions that could be funded by a SIB require strong evidence of their ability to achieve better social outcomes. For instance, permanent supportive housing has been shown to be an effective intervention for individuals who experience long-term homelessness and have multiple barriers to housing, such as a mental illness, substance addiction, or physical handicap. Numerous studies have found that once these individuals are housed, their health improves and residential stability increases. This, in turn, dramatically decreases their use of emergency rooms, inpatient hospital visits, jails, and shelters, which results in significant downstream government savings.

SIBs thus focus on social metrics that reflect an improvement in program participants' lives and can be tied to governmental cost savings. These metrics target outcomes rather than what would be considered inputs (e.g., the number of low-income individuals participating in the program) or outputs (e.g., the number of housing units created). By focusing on how participants have benefited from a program beyond what would have happened in its absence, SIBs provide a stronger indication to investors of the social impact of their investment. Metric selection is no easy task, however. The designated metric has to be carefully designed such that service providers do not have perverse incentives, such as treating "easier" or lower-risk populations.

An independent auditor evaluates these social metrics over the life of the SIB to document whether outcomes have been achieved and investors should be repaid. A third-party auditor provides investors with the confidence that outcomes will be determined fairly and reliably. Importantly, through a robust evaluation design, this entity ensures that outcomes are attributable to the program itself and not some other factors, such as a better economy or changes in governmental policies. The UK SIB, for instance, uses a quasi-experimental evaluation design and compares the program participants against a comparison group comprised of similar individuals. SIB evaluation relies on a robust data collection system that recognizes the importance of technology, but also human capital in ensuring that data collection protocols follow best practices and data is input in a timely and accurate manner. In addition to an auditor, SIB intermediaries also work with a separate evaluation team to track interim progress on outcomes and use this information to make course corrections and facilitate success along the way.

SIBs are unique in their use of social outcomes to trigger investor repayment. They monetize social impact by calculating the cost savings associated with better outcomes, such as fewer hospitalizations, that are a direct result of the SIB-funded program and are above and beyond what would have happened without the intervention. Investors receive returns on a sliding scale: the better the outcomes, the higher the return. In this way, financial returns are directly linked to and contingent upon social impact.

The Need for Improved Social Impact Measurement

The ability to accurately measure and demonstrate socially beneficial outcomes is one of the core requirements of being able to attract investment dollars through SIBs. Accurate tracking and reporting of investments' social impact would significantly benefit the entire impact investing sector. Data on social metrics would facilitate investors' selection of investments. Just as an investor might choose an investment based on its financial risk and return profile, he or she can select an impact investment using knowledge of its social risk and return. Greater transparency of investments' impact would allow for increased accountability for funds; rather than assuming funds contribute some level of social good, investors would have evidence that their funds are having their intended impact. Furthermore, tracking impact as part of overall performance would have the beneficial byproduct of organizational learning within social enterprises, which can drive program improvement and make these organizations more attractive opportunities for investors. With the use of common measures, investors would be able to compare investments with regard to social impact within and across portfolios, as well as against industry benchmarks.

Fortunately, the impact investing sector has been making tremendous progress in recent years in erecting the infrastructure to support measurement of social performance. New market tools, such as the Impact Reporting and Investment Standards (IRIS) and Global Impact Investing Reporting System (GIIRS), have been developed to respond to impact investors' needs. IRIS provides standardized metrics to track social, environmental, and financial performance. It is a common language that facilitates comparison between social enterprises on, for instance, the number of jobs created or number of individuals housed. Using IRIS metrics, GIIRS rates companies and funds along social and environmental criteria. GIIRS allows investors to compare investments and analyze individual investments over time.

Although this progress is certainly encouraging, the sector still lacks investment opportunities, especially for those investments with reliable evidence of both financial and social performance. In a recent survey conducted by J.P. Morgan, a group of impact investors identified the shortage of quality investment opportunities and inadequate impact measurement practice as two of the top three challenges facing the sector.[1] Social Impact Bonds are an innovative product that strives to fill these gaps.

Conclusion

We expect SIBs to appeal to a wide range of impact investors. The investment's potential social and financial returns would be articulated upfront so investors would have sufficient information to price the risk they are undertaking. The instrument's structure is flexible so it can be amended to appeal to mainstream as well as more philanthropic investors. While the UK SIB has a "cliff effect" where investors lose their principal if social impacts fall short of a certain threshold, other SIBs could incorporate mitigation measures, such as a first-loss reserve.

While the UK issuance is currently the only SIB on the market, governments around the world are exploring the concept. In the United States, interest has been percolating at the local, state, and federal government levels. In January 2012, Massachusetts became the first state in the nation to formally announce its intention to pursue SIB contracts. The federal government shortly followed, with the Department of Justice and the Department of Labor stating that they will support Pay for Success pilots through funding competitions this year.

Like impact investing, Social Impact Bonds are not an answer to the funding challenges of all enterprises in the social sector. Where they do work, they present information on social impact alongside data on financial performance. The strong interest being expressed by governments at all levels and in various geographies reflects a considerable shift in the collective mindset away from funding good intentions to incorporating measurable social impact into investment decisions. The more we can incorporate such robust measurement, the more we can attract institutional and other investors to participate in these opportunities. We envision that such trends will soon lead to a large, dynamic impact investing sector, which would direct new sources of capital to community development efforts across the country. CI

The Potential of Social Investment Bonds and the CRA

A good example of the potential power of a financing tool that measures social outcomes may be in the application of Community Reinvestment Act (CRA) funds to Social Impact Bonds (SIBs). The CRA is intended to encourage depository institutions to help meet the credit needs of the low- and moderate-income (LMI) communities in which they operate, consistent with safe and sound operations. While SIBs do not currently meet the investments tests for CRA, efforts are underway to structure the instrument to make it CRA qualified, which would open up a new pool of institutional liquidity for SIBs within the banking community. It is expected that SIBs will be developed on a community-by-community basis and will primarily address issues that face LMI individuals. As such, there is expected to be significant overlap with CRA's geographic, community needs, and LMI population requirements. In addition, the high standard of rigorous measurement of SIBs will enable more impactful use of CRA funds, thereby expanding the range of opportunities for CRA investments. With clearly defined measurement, a CRA investor is better able to articulate the community development needs and measure the impact of the CRA investments on the actual outcomes of the geographies and populations being served. With strict enforcement of the financial discipline and creditworthiness of transactions, CRA requirements can, in turn, strengthen the pipeline of strong impact investing deals with underlying measurement tools to define and track outcomes, especially when these deals are managed by a clearly defined intermediary to drive the implementation and measurement process.

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1. This article reflects the opinions of the author, and not necessarily those of Wells Fargo.

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