RURAL COMMUNITIES AUSTRALIA

SOCIAL IMPACT BONDS AND SYSTEMIC RISK:

A PRELIMINARY ANALYSIS

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A PRELIMINARY ANALYSIS

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Introduction

Social impact bonds (SIB) have been proposed as a financial engineering strategy to increase the flow of funds to social purposes, and to improve the effectiveness of the use of those funds. The concept is straightforward. Investment is sought to fund businesses that deliver needed social outcomes. Because such businesses are assumed to carry greater risk than standard businesses a government guarantees the investment against business failure, or against the failure to deliver the social outcomes, or both (the 'bond'). Returns to such investors are typically lower than are available in the market but sufficient, it is reasoned, to attract funds. Centrally, it is expected that investment of this kind will increase the flow of funds to social purposes from the current levels of funding flowing to such uses from not-for-profit entities usually sourced from grants or philanthropy. As a result social needs will be better met. Explorations of this financing mechanisms have been appearing in the literature for the last several years (Faia 2014; Jackson 2013; Dagher 2013; Warner 2013; Liebman 2011).

Stated in this way the idea seems attractive. If the delivery of some social outcomes—the meeting of social needs—can be placed on a business footing it may become self-sustaining. Moreover, the full range of business disciplines will be brought to bear on the operation; and there is confidence that this added rigour will see funds used with greatest efficiency and to greatest effect. The government guarantee (which, as it happens, is not a bond at all) offers an attractive incentive to investors to make funds available. Governments in turn are relieved of some of their obligations to fund social needs. Applications to a number of government sectors, including the criminal justice system and health, have been examined (Fitzgerald 2013; Olson & Phillips 2012; Baliga 2011; Fox & Albertson 2011).

Successful examples of what has been called 'social enterprise' are not difficult to find (Bornstein & Davis 2010; Brooks 2009). It is therefore clear that some social needs can be effectively addressed through social enterprise. Assuming the free cash flows generated by them are enough to deliver a reasonable return on investment, an investment component can be reasonably incorporated into the system, through the SIB, in order to expand such enterprises and encourage new ones. It is difficult, on the face of it, to see anything other than an array of positive outcomes associated with the SIB strategy.

A closer analysis of the SIB model, however, suggests a different picture. The incentives that are brought into play by the SIB mechanism may change the ways in which actors in the SIB system behave. Over time the sector may be transformed; we argue, not for the better, in human terms. The ability of the sector to meet social needs may be narrowed. These effects may reach into social cohesion and social equity, diminishing the ability of the sector to implement the principle of priority to the least advantaged. In consequence the social task of delivering equal opportunity for the development of full human capabilities to the most vulnerable may be made not easier, but more difficult. This may be a counter-intuitive result, but it seems to follow, we submit, from the analysis.

Our argument is presented in two stages. Firstly, we analyse the initial position of the four main actors (or agents, or stakeholders) in the system: the investor/philanthropist; the not-for-profit charitable organisation; the communities it works with; and the government providing the SIB guarantee. Secondly, we analyse the changes to the positions and behaviour of these actors brought about by the implementation of the SIB and the sector-wide and social changes brought about over time by these changes as the SIB becomes a primary method of funding social outcomes and meeting social needs.

The initial state: before the SIB

Although it contains only four principal actors, the system within which the SIB operates to fund and deliver social benefits is not simple (see Fig.1). Governments and private enterprises have well-documented complexities on many levels. NfP organisations and Communities have different kinds of complexities to consider. Any significant new element introduced into the system, such as the SIB represents, is likely, we may predict, to generate changes which cascade through the system and affect all four actors in many ways. In order to track these potential impacts we therefore begin by describing in general terms the system as it exists before the introduction of the SIB, focusing in turn on each main actor.

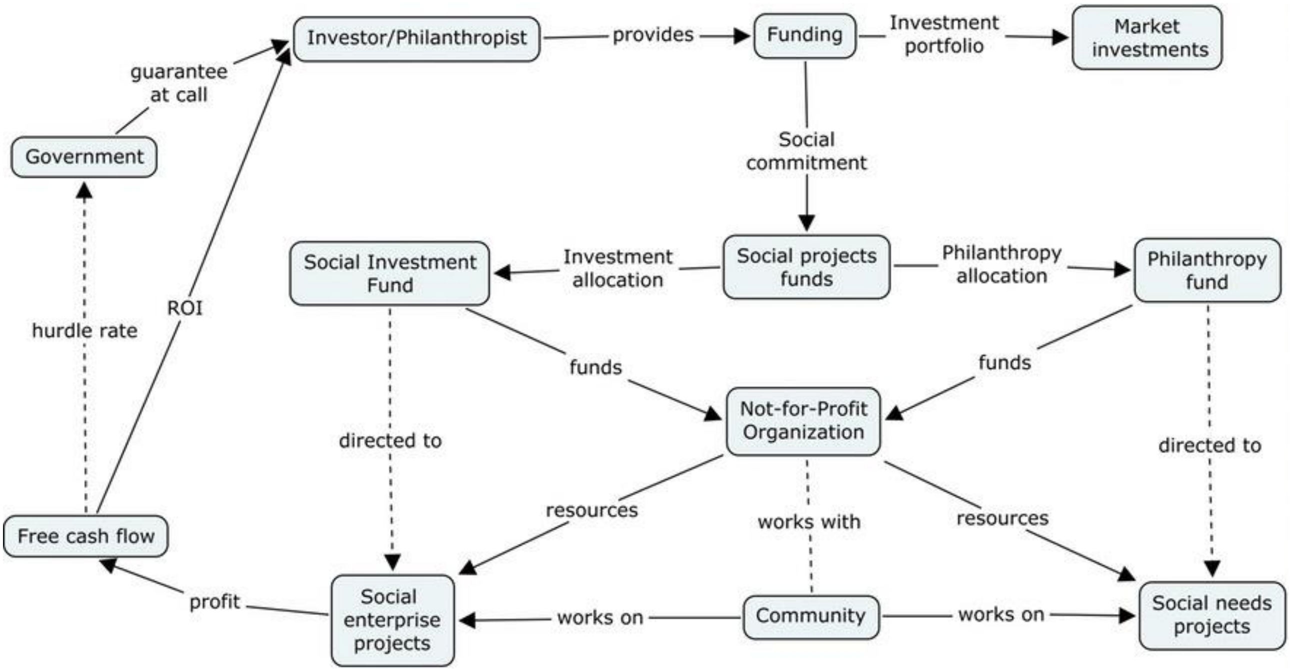

Fig.1: SIB System

Philanthropist

Philanthropy is a pillar of the not-for-profit sector. The first actor in the system is thus the *Philanthropist.* The discretionary funds which make philanthropy possible are likely also to fund an investment portfolio. The two allocations have different purposes and different results. Philanthropy by definition provides direct primary benefits to people or areas (such as the environment) other than the philanthropist; we will term these *social benefits*. Investment, if successful, primarily benefits the investor. There is overlap: some philanthropy attracts tax benefits; philanthropy may improve the society at large, of which the philanthropist is herself a part; and the companies funded by investment provide social benefits through multiplier and other effects. Nevertheless the two purposes are distinct—one private, the other social—and they are often found together, drawing on the same discretionary funds. Most philanthropists are in a position to act philanthropically because they are also successful investors.

The allocation of discretionary funds to these purposes is likely to vary as the general economic conditions change. In general, and not unreasonably, philanthropy ranks second: funds are allocated to philanthropic purposes once investment goals are achieved. Clearly there are lag times when investments may not be performing as well as hoped but philanthropy nevertheless continues. Over time, however, if that trend continues, funds will be allocated away from philanthropy towards to investments or other commercial projects which offer a better financial return. Corporate philanthropy, undertaken within the general framework of managing for shareholder value, is likely to be even clearer about that priority.

The central fact for the purposes of this analysis is that philanthropy is primarily undertaken altruistically, to assist in meeting a social need, with no expectation of substantial private benefit to the philanthropist, other than tax benefits. Without that motivation philanthropy, as a sector in its own right, would be unlikely to grow.

Not-for-Profit (NfP) Organization

The second key actor in the system, the *Not-For-Profit (NfP) organisation,* is governed by its social mission. Its success is measured by the degree to which that mission is realised. This stands in contrast to the private enterprise which, although driven by a vision and mission that may be broadly based, exists primarily to deliver economic results in the form of shareholder value. It has been remarked that not-for-profit does not mean 'for loss': clearly every NfP organisation must remain solvent. It can even initiate commercial activity and can build its balance sheet by it. But that asset accumulation cannot be distributed: it must be applied to the organisation's work, to further its mission. However, the NfP organisation primarily funds its work from philanthropic sources, such as foundations, corporations or private philanthropists; and from government grants at national, state, regional and local levels.

Community

The NfP organisation works with individuals, groups or communities with unmet social needs (remembering that social can include environmental, economic, cultural and other needs). Collectively these constitute the third actor in the system, which we will term the *Community*. By unmet need we mean that none of the three major productive institutions of society—public enterprises, private enterprises, and household (Stretton (2000)—has been able to meet that need. To put it another way, these individuals, groups and communities have not been able to meet their needs fully by drawing on the productive resources of the three institutions. The NfP organisation attempts meet that gap. Philanthropic and government funds also flow directly to individuals, groups and communities in need without going through an NfP organisation.

Government

The fourth actor, *Government,* meets social needs through the various channels of government spending. Through tax strategies governments provide incentives to private enterprise to direct resources or increase investment in commercial activities that deliver social outcomes. Governments support NfP organisations directly through block funding and through targeted social initiatives. Governments provide grants directly to individuals, groups and communities with unmet social needs, or provide funding for individuals to choose service providers to meet their own needs. Government funding can flow to NfPs or to communities through other sectors, such as university research funding.

Funding for social benefit, from whatever source to whatever entity, is evaluated against well-established criteria. The social benefit must be clear, highly ranked (as discussed further below) and not easily met from existing funding sources. The capability of project participants to deliver anticipated project outcomes must be demonstrated. Project goals and budgets must be professionally developed, drawing where possible upon convincing research evidence and case study support. Professional financial management and reporting procedures must be in place. Funding is often awarded competitively against these and similar criteria.

Such criteria incorporate good management principles and practice, and seek to maximise project outcomes and their social benefits by efficient use of resources. The project funding is not, however, a financial investment and does not seek a financial return. The returns it seeks are social benefits to address unmet social needs. Often these needs are framed in terms of disadvantage, under the principle of priority to the least advantaged (Woolff & De Shalit 2007). In practice, of course, many other factors come into play and that principle is often compromised.

The system after SIB intervention

The introduction of the SIB mechanism is likely, we argue, to produce system-wide changes to the sector. We now outline these projected impacts with respect to each of the four principal actors. These projections are derived by applying the normal motivations and behaviour of each of the principal actors as they go about their business. In that sense it is still business as usual, but within in a new funding framework. We follow the logic of the work as it applies to each actor, as described above, under these altered conditions.

Investor

Under the SIB regime the philanthropist will become more an *Investor*: given a choice between allocating discretionary funds either to continuing philanthropy or to SIB investment the financial and risk incentives favour funding the latter. Funds are therefore likely to move away from philanthropy to SIBs.

Importantly, there are reasons to question the assumption that the SIB mechanism will bring more funds into the system than were formerly available in the philanthropy model. Such an assumption goes against rational decision-making. Formerly the Investor divided her discretionary funds between market investments and philanthropy (with associated tax breaks). The SIB mechanism presents a third vehicle for discretionary funds. Since SIBs offer a significantly lower return than market investments, the Investor is unlikely to divert significant funds into it from her market investments, even with the lower risk profile created by the government guarantee. It is more rational to assume that funds will be diverted into the SIB from the philanthropy pool, provided the return from the SIB is greater than the tax advantages from philanthropy. The movement of funds thus looks more like a zero sum game than an increasing funding pool.

The Investor now has to make a decision on which SIB organisations or projects she will invest in. While the nature of the social outcomes of the project remains a factor, more attention is likely to move to the financial outcomes of the project. The Investor is likely to favour projects with a greater return on investment, at least to the level of the Government guarantee; beyond that, standard project risk criteria will probably apply. The Investor will also tend to favour NfP organisations which have a track record in delivering financially successful SIB projects. Increasingly project proposals are likely to be evaluated according to the standard business criteria of financial risk and reward: the nature of the social benefit being provided may become correspondingly less important.

Not-for-Profit Organization

These changes at the Investor level imply systematic changes for the NfP Organisation. In order to attract funding the NfP will increasingly be required to bid on SIB projects. It must prioritise community projects that can be structured as SIB projects, regardless of social need: if a project cannot be structured as an SIB project, it will be ranked lower and receive less organisational attention and fewer organisational resources than SIB projects. Such projects will be characterised more by their ability to generate a return to investors and to attract a guarantees from government.

In a similar way, the NfP is likely to need to prioritise communities it works with by considering whether the operational and commercial capabilities required to implement the SIB project are present in the community. To engage with a community on an SIB project where the community lacks such skills and capabilities imposes additional costs and resources which works against the ranking of the project and the community.

This change may diminish the centrality of the mission of the organisation as a NfP organisation. As noted, the distinguishing character of the NfP organisation is its social mission. In order to attract SIB funding it is likely now to be required to act more as a commercial organisation. Its legal structure may remain not-for-profit, but operationally it will need to take on a different character, where decisions are taken according to their impact on commercial outcomes and for predominantly commercial reasons. This seems to require a comprehensive change in the culture of the organisation, from one dedicated to supporting the disadvantaged to one focused on financial outcomes while hoping for an ancillary social benefit.

In this way the NfP organisation's own judgement about social needs—priority to the least advantaged—based on its direct relationships with communities is likely to be replaced by a requirement to meet the increasingly commercial demands of Investors. It will be required, in effect, to operate commercially. This reconfiguration of the mission and the corresponding cultural shift is a journey many NfP organisations find difficult to make (Bush 1992). Evidence suggests that cultural changes of this kind enforced by government or private funders can drive the best people from NfP organisations. These people have come to the NfP organisation, often at significant compensation disadvantages, because of their belief in its mission. They tend to be the repositories of long-term corporate knowledge about the work of the organisations and its communities and stakeholders. They do not stay long once that mission is significantly compromised.

Community

Cascading changes are likely to flow through to the *Community*. Typically Communities who are working with NfPs have a range of social needs, which are prioritised for project action with the NfP organisation. As noted, under the SIB regime these priorities will change. If the projects require external resourcing through the NfP priority will be given to those social needs and associated projects that can be structured as SIB projects. Other social needs—that is, social needs which cannot be addressed through SIB projects--however pressing, must inevitably slide down the ranking. Again, as noted, the Community will need to adopt the business model of the SIB and to develop the commercial capabilities and skills required to run a successful business at a level that generates the returns demanded.

From the Community perspective there are limitations to these outcomes. The Community itself is likely to be, to a greater degree, removed from making project selection decisions: its perceptions of social need and of cultural priorities are unlikely to be considered in the ranking process ahead of commercial outcomes. The Community will have a reduced level of ownership in the project: it will now be, in a very real sense, owned by the Investors. Such a structure is unlikely to contribute to community-decision making or broad community capability and resilience. Importantly, economic value generated by the SIB project will not belong first to the Community but to the Investor; the Community will harvest residual value, if it is generated. The opportunity costs of a focus on SIB projects will be material and unmeasured. The Community will be required to accept these priorities: it has little bargaining power to bring to the table.

The SIB value proposition includes the assumption that Communities adopting SIB project will receive training in business disciplines and that this increased capability is generalizable to other projects. That may be the case, although the evidence for such transfer is not strong. But there are significant Community costs, as outlined above. And, of course, it may well not to happen at all: competitive business demands best-cost providers (Thompson et.al. 2014) and these may not come from the Community. The imperatives of delivering a return to Investors will be paramount.

Moreover, there is a simple observation to be made that is familiar to anyone experienced in business: the majority of entrepreneurial businesses, of the kind likely to be associated with SIB projects, fail. That proportion may be increased when the requirement of delivering a response to a specified social need is added. One has at least to ask the question: if there is a real business opportunity here that is likely to be sufficiently profitable to generate the required returns, why isn't someone doing it already? It may be possible to develop the idea of a SIB project: the reality of implementing it is much more demanding.

Government

How does the Government fare under the SIB regime? Overall, it is likely to do quite well. It would carry significant risk only when projects fail; and that is money which would have had to be expended on such social needs anyway. Some projects should succeed in meeting a social need, at least to some degree, and to that extent will have saved the Government some money. Moreover, a degree of project and financial risk will have been transferred out of the government sector. Some contingency funds would need to be quarantined, however, and these would not be available for other social needs projects.

The Government can also impose significant conditions in the terms of the guarantee to reduce its risk. Since the call on the Government guarantee is linked to rates of return, it is likely to impose terms which bear almost exclusively on the commercial operations of the project. Its agreement to participate in a project as guarantor is thus likely to drive the project even more strongly into a commercial operation, strengthening the sector-wide potential impacts outlined above.

Politically the Government could use the guarantee program to claim it is supporting the private sector while addressing social needs. Because of the financial and risk advantages to Government there is an incentive for a Government to require most governmental action to address social needs to take the form of an SIB, or an equivalent social investment, and to seek to avoid other expenditure on social needs if it can. The analysis outlined above, however, suggests that such a strategy would be unlikely to match and meet the range of social needs as they are lived at the community level.

Summary and conclusion

We have argued that the central assumption motivating the SIB mechanism—that providing for a return on funds directed to meeting social needs will increase the volume of those funds and improve their effectiveness—may not prove to be justified in practice. In particular, it seems to ignore systemic effects that may have negative impacts on the sector as a whole. The SIB system operates dynamically: decisions taken by the principal actors are iterative and cumulatively are likely to create large shifts across the sector. Among the most important of these may be, we suggest, the following:

1. The funding pool available for social purposes may increasingly move out of philanthropy into the SIB vehicle. Philanthropic fund pools may shrink, with significant consequences for a wide range of NfP organizations and their social benefit activities.

2. This move may favour social projects which can be funded by investment and which deliver financial returns on investment over those which do not, irrespective of social need.

3. NfP organizations may move their focus away from a broad range of social projects to a narrower range of projects that are attractive to investors.

4. NfP organizations may be required to operate in a more commercial mode which may be at odds with their mission and ethical commitments.

5. Communities may begin to limit their focus on the full range of their social needs to those needs which can be structured as SIB projects and deliver a financial return to investors. Social and cultural needs judged to be priorities by the community may become increasingly irrelevant to decision-making about these projects.

6. The broader objectives of work at the community level, including development of broadly-based capabilities and skills, and community ownership of projects, may not be well supported.

7. Governments may increasingly shift risk and costs out of the government sector by narrowing government action on social needs to those that can be met by the SIB model.

There is no claim here that this is the only form of the SIB vehicle being proposed or in existence; but it is one form that is in place and which is attracting real interest in the sector. To that it extent it warrants close investigation. Our intention is to provide a reasoned caution: that this relatively small shift in financial engineering may well have negative impacts across the sector, and therefore on the lives of the people in real need for whom the sector exists.

We have argued that these systemic impacts are not speculative or implausible: they are derived by applying the normal motivations and behaviour of each of the principal actors as they go about their business. What has changed is only the introduction of the SIB vehicle and its wide promotion in the sector. Once that model is adopted by philanthropists as the preferred vehicle for social funds the effects of that decision may cascade through the system, with impacts for the whole sector. Most of these impacts, we submit, have not been anticipated in the SIB model nor have they been systematically analysed and understood. At present they present themselves as unanticipated collateral impact. We urgently need to understand more about it. We have presented here the motivations for that work, and the scope of the analysis that will be required.

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