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When is the Right Time to Use a Social Impact Bond?

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Introduction

Social Impact Bonds (SIBs) continue to intrigue governments, investors, and the social sector. A SIB is a form of outcomes based funding, where investors provide upfront capital for social services, and then are repaid with a return by an outcome funder (also known as a 'commissioner' in the UK) subject to a service provider achieving the agreed results.

The mechanism can be attractive to governments and institutions, who stand to save on the costs of addressing social challenges, whilst sharing risks with third parties.

However, despite a decade of transactional experience since the first SIB (the Peterborough SIB), there are still doubts about the mechanism. A recent review procured by the UK's Department for Digital, Culture, Media & Sport noted that there was some reticence by stakeholders to use SIBs, due to either suspicion of the mechanism, or a lack of understanding of how it works. Other doubts include whether SIBs are truly effective in mobilising additional capital or whether the high transactional costs are worth the investment.

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Palladium's perspective, based on advising clients on the design and evaluation of SIBs and other outcomes-based funding, and from designing and implementing Utkrisht (a Development Impact Bond), is nuanced.

"Investors and outcome funders must always remember that a SIB is one potential tool, of many, that can be utilised towards the desired social outcome," says Preeth Gowdar, Director at Palladium Impact Capital (formerly Enclude). "The crucial thing to evaluate is whether it is the right tool."

When is a SIB the Right Tool?

A Social Impact Bond may be the right transaction for stakeholders who can answer 'yes' to most of the following questions:

1. Are your outcomes specific and measurable?

Above all, a SIB will rise and fall on its definition of success, i.e., its outcomes. Those outcomes must be specific, and they must be measurable. If an intervention does not have a clear measure of success, it is not appropriate for a SIB.

2. Do you have strong evidence that the work will be successful?

Investors typically crave certainty. Investable SIBs are those that can demonstrate they will achieve the social return required to get an investor a financial return. The greater evidence base of a likely return, the easier an investor's approval processes will be. Building on existing long-term social programming may be a good start.

3. Is there scale to justify the cost? Is there an exit strategy?

There will undoubtedly be material costs and efforts to set up the SIB, and so generally scale (of impact and/or investment) is required to realise that investment by all parties. Another crucial element to consider in that justification is an exit strategy. What happens when the SIB is finished? Does there seem to be an appetite to pick up the initiative, or is the fact the intervention ends with the SIB justifiable?

4. Are the risks/rewards appropriate for each stakeholder?

Contractually, a SIB involves more stakeholders than a basic grant. It has fundamentally different players with different risk/reward incentives and appetites. An effective SIB needs to balance those risk/reward appetites of each party. Outcome funders are interested in robust results at a fair price. An investor needs certainty of return from a service provider it trusts. A service provider needs to know it will be paid for delivering.

The risk/rewards should be balanced between these players for a SIB, ensuring one party is not carrying undue risk (which will increase the prospects of a party pulling out before contracting).

5. Is there a clear route to market, with the ability to engage with potential SIB players?

Many SIB outcome funders are government agencies with procurement regulations in place which must be followed before agreeing to a SIB. However, most jurisdictions also allow for competitive dialogue or early market engagement. This is a crucial step, as it will allow the participants to become better aligned on the design and style of the intervention.

6. Have you identified organisations that are interested?

SIBs come from myriad sources – government-led, intervention-led or sometimes even investor-led (i.e., capital in search of an outcome). However, each party needs to be aligned with the intervention. This means that the outcome funder has a vested interest in the results, the investor understands the mechanism and the results, and the service provider has a track record in the intervention. When evaluating whether to use a SIB, look for an outcome funder who has a vested interest in paying for these results. Without an outcome funder, establishing a SIB will be challenging.

7. Are there simpler forms that have the same short-term result?

SIBs do still come with a transaction and time cost; whilst effective in crowding in some forms of new capital, the design costs are still high and lead times can be long. A SIB may be an effective mechanism for a design that will decrease costs to outcome funders in the long term at a lower financial risk. However, if there is a simpler mechanism, or the timeframes are short, other mechanisms (including milestone-based grants, impact investments or social business startups) may be more appropriate.

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We work with corporations, governments, investors, communities, and civil society. With a global network operating in over 90 countries, Palladium is in the business of making the world a better place.

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