# SECOND THOUGHTS ON SOCIAL IMPACT BONDS

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*This piece is a comment offered in conjunction with Deborah Burand's article,* Globalizing Social Finance: How Social Impact Bonds and Social Impact Performance Guarantees Can Scale Development, *which can be found at 9 N.Y.U. J.L. & BUS. 447. An earlier version of the comment was presented on November 9, 2012 at the N.Y.U. Journal of Law & Business Fall Conference on the Law and Finance of Social Enterprise.*

Social Impact Bonds ("SIBs") are just one of the many variants of innovative financing techniques garnering more and more attention today in the world of social finance. Many of these techniques focus on the intersection of and collaboration across different sectors: various levels of government, development financing institutions, philanthropic and community development organizations, and the for-profit private sector. The SIB is rightly lauded as "an innovative way to fund promising new programs at no cost to taxpayers."[1]

At the heart of the SIB structure is the concept of pay-for-success. How much the government pays for services depends on how successful the service has been. The investors only get paid if the program is successful. To the extent that a program is unsuccessful, the private investors in the SIB bear the pro-

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1. Press Release, Mayor Bloomberg, Deputy Mayor Gibbs & Corrections Commissioner Schriro Announce Nation's First Social Impact Bond Program (Aug. 2, 2012), http://www.nyc.gov/portal/site/nycgov/menuitem.c0935b9a57bb4ef3daf2f1c701c789a0/index.jsp?pageID=mayor_press_release&catID=1194&doc_name=http%3A%2F%2Fwww.nyc.gov%2Fhtml%2Fom%2Fhtml%2F2012b%2Fpr285-12.html&cc=unused1978&rc=1194&ndi=1 [hereinafter NYC SIB Press Release].

gram costs. Thus, the private sector, and not the government or the service provider, bears the financial risk of program failure. Another much-touted benefit of SIBs is that the government achieves "cashable savings." These savings, however, derive from the preventive nature of the social programs and not from the SIB financing structure. For example, in the Rikers SIB, the government's total costs will be reduced because the cost of incarceration exceeds the cost of successful prevention programs.[2] This would be true if the same prevention program were directly funded by the government. Pay-for-success compensation and remediation programs are not innovations. What is new about SIBs is that they provide up-front financing for these services from non-governmental sources and transfer the financial risk of program failure to the finance provider.

Before being swept up in the exuberance surrounding SIBs, and before trying to replicate the model globally, as Professor Burand contemplates, a moment of reflection is in order. This comment sets forth questions about SIBs that merit further analysis. The overarching question is this: are SIBs the best way to achieve the intended results, or are there simpler, more efficient and perhaps even more effective ways to finance programs that realize the social benefit and the cashable savings?

Are SIBs cost effective? The starting point, as proponents of SIBs like Professor Burand readily acknowledge,[3] is that figures regarding expenses incurred in structuring and managing SIBs are not publicly available. Some suggest that SIBs will get less expensive over time. Although this may be true for some structuring costs or for SIBs among the same parties for the same programs, I suspect that the structuring of SIBs will continue to be rather expensive. (Other structured financing transactions, including public/private financings of infrastructure projects to which Professor Burand compares SIBs, continue to be very expensive undertakings despite decades of ex-

2. *See* Deborah Burand, *Globalizing Social Finance: How Social Impact Bonds and Social Impact Performance Guarantees Can Scale Development*, 9 N.Y.U. J.L. & Bus. at 457-58 (2013); *see also Fact Sheet: The NYC ABLE Project for Incarcerated Youth*, City of New York Office of the Mayor (Aug. 2, 2012), http://www.nyc.gov/html/om/pdf/2012/sib_fact_sheet.pdf.

3. *See, e.g.*, Burand, *supra* note 2, at 467-68.

perience.) To illustrate, the SIB structure requires five different parties:

1. A city or other government entity;
2. One or more private sector investor(s) (in the case of the Peterborough SIB there were multiple investors,[4] and in the case of the Rikers SIB there was, in addition to the private investor, a philanthropic donor providing the guarantee to limit the investor's risk[5]);
3. A lead contractor or intermediary between the government entity and the service provider;
4. A service provider; and
5. An independent assessor (plus, in some cases, the advisor to the intermediary company).

Think about the resources expended by each of these parties, and their lawyers, in the negotiation and execution of a SIB. In light of the size of these transactions, which are relatively small, these resources can be quite substantial.

Do the fees associated with SIBs make the structure too costly? The SIB structure implies additional costs throughout the life of the SIB—the lead contractor or intermediary, the advisor and the independent assessor must all be compensated.[6] It is unclear from the information that is publicly available how these service providers are compensated and what capital, if any, they will need in order to scale up their operations to perform as required in connection with these SIBs. These fees are an ongoing cost of the SIB structure that would *not* apply in a direct contract between the government and the service providers. It would be interesting to know what portion of a SIB's annual investment is paid to the social service providers in fees and what portion goes to fund startup and ongoing transaction costs.

4. NYC SIB Press Release, *supra* note 1; *see also* Burand, *supra* note 2, at 452-53.

5. This is the role of the Bloomberg Philanthropies. NYC SIB Press Release, *supra* note 1; *see also* Burand, *supra* note 2, at 457-58.

6. In the existing SIBs, these payees are all non-profit entities; but they need not be. Concerns that arise whenever the private sector provides services traditionally left to the government are not addressed in this comment and, in any event, are not unique to SIBs.

Are the SIBs' financial costs too high? In the Rikers transaction, Bloomberg Philanthropies is providing $7.2 million to serve as a guarantee for the Goldman Sachs investment.[7] Bloomberg Philanthropies is actually funding its part *pro rata* with Goldman Sachs'.[8] What are the financial and opportunity costs of funding the intermediary, MDRC, in this way? As Professor Burand notes, even if these funds are available in the future to support other programs, they will be tied up for several years before this can happen.[9] Although we know that Goldman Sachs stands to make up to $2.1 million in the transaction,[10] the pricing of the Goldman Sachs investment is unclear. According to the press release, Goldman Sachs will "break even" if recidivism is reduced by 10%.[11] What does "break even" mean in this context? Is Goldman Sachs receiving a risk-adjusted market rate of return, receiving a below-market rate of return, or forgoing the interest on its loan altogether? Given the track record of the service providers and the large portion of the investment that benefits from the cash collateral provided by Bloomberg Philanthropies, is cheaper financing available?

More importantly, how will the various execution risks outlined by Professor Burand be allocated among participants, and what will be the consequences of such allocation? There is little information on the relative rights of the parties during the life of the SIBs. How are decisions to be made in the event that there is a need to adjust the programs? Who has control over whether these changes can be made? How would they affect the terms of the payment to the service providers or the investor? Are there any conditions to the investor's and the guarantor's obligation to fund? How can one be sure that these decisions will be made based on what is in the best interests of the populations being served? Note that the Goldman Sachs investment in the Rikers SIB is made over four years.[12]

7. Burand, *supra* note 2, at 458; NYC SIB Press Release, *supra* note 1.

8. NYC SIB Press Release, *supra* note 1 ("Bloomberg Philanthropies will make a $7.2 million grant to MDRC over that same four-year period . . . .").

9. Burand, *supra* note 2, at 487.

10. David W. Chen, *Goldman to Invest in City Jail Program, Profiting if Recidivism Falls Sharply*, N.Y. TIMES (Aug. 2, 2012), http://www.nytimes.com/2012/08/02/nyregion/goldman-to-invest-in-new-york-city-jail-program.html.

11. NYC SIB Press Release, *supra* note 1.

12. *Id.*

What if conditions are not met and funding is suspended? Would the City's Department of Corrections then fill the gap, or are these social programs (and the financial viability of the non-profits engaged to execute them) at risk?[13]

Finally, although the government only pays for success, it appears that the providers of the social services are paid irrespective of their success. Thus, the risk of failure is on the investors and not the service providers. The idea of paying service providers based on their performance is similar to the idea (often cited by SIB enthusiasts) that an ounce of prevention is worth a pound of cure. The idea is not new, and its appeal is obvious. But, in the case of SIBs, the pay-for-success concept applies to the government and the investors but not the service providers. Would a pay-for-success payment scheme that also incentivizes the service providers make more sense?

Compare a SIB to a more straightforward arrangement where the government contracts directly with a service provider on a pay-for-success basis.[14] This arrangement alone would result in "cashable savings," while providing financial incentives to the service providers themselves. One option is for the initial payments to be conditional, subject to claw-backs if the desired results are not achieved. The obligation to make the claw-back payments could be guaranteed by a philanthropic investor. In this simple approach there are two or three parties. Another option is for the payments from the government to be due only once results are measurable. In this case, the service provider would need to raise funds up front to finance its programs. Perhaps the service provider could tap philanthropic investors to provide a guarantee comparable to that which the Bloomberg Philanthropies is providing in the Rikers SIB. This guarantee would be leveraged to raise money from impact investors, such as Goldman Sachs. Although this structure has some similarity to the SIB structure, the contractual relationship relating to the services would be solely between the service provider and the relevant government agency. The service provider could also pledge the fu-

13. Professor Burand suggests ways to minimize these risks, Burand, *supra* note 2, at 467-81, but her suggestions do not eliminate the risks and, to some extent, would add to the expense and complexity involved in SIBs.

14. This would avoid the intermediary risk described by Professor Burand. *See id.* at 472-73.

ture payments from the government to guarantee a loan. Given that the SIBs are using social service providers with "proven track records of success in delivering their respective contracted social service interventions,"[15] one should not discard the possibility that the service provider, with enforceable government contracts in-hand, could independently raise the funds needed to scale up.

Would it be better for SIB investors, such as Bloomberg Philanthropies and Goldman Sachs, to fund organizations like the Osborne Association and the Friends of the Island Academy to permit them to reach scale, and for the government to contract for preventive services directly from these providers on a pay-for-success basis? The SIB structures provide working capital to service providers as they perform their services. But the long-term capital needs of non-profit social service providers to invest in infrastructure and capacity is not addressed by the payment for services contemplated by the SIB structure. Promoters of the SIB structure hope that the SIB model might be replicated and scaled up to significantly increase the delivery of preventive services. The service providers would need to grow for this to happen, and the payments made to service providers over time for services under the SIB structure do not address this need. Perhaps the resources made available by the philanthropic and impact investor community would be better spent by funding the service providers directly.

The complexity of the SIB structure is exacerbated when it is applied across borders to the developing world. As Professor Burand notes,[16] in addition to the issues identified above and in her article, conditions such as weak governance at all levels of government, severely limited resources for financial services, and limited "cashable savings" all increase the risks associated with implementing the underlying social programs and the financial structure of the SIBs. In this context, perhaps two moments of reflection and a deep breath are advisable before jumping on the SIB bandwagon. In a cost-benefit analysis, just adding an element of foreign exchange or sovereign risk protection to an already complex structure may tip the balance away from a SIB structure in favor of a simpler approach.

15. *Id.* at 457.

16. *See* Burand, *supra* note 2, at Part IV.

Take an easy example of such a simpler approach: the World Bank Green Bonds. The World Bank has issued almost $3.5 billion dollars in Green Bonds.[17] These bonds are obligations of the World Bank and thus benefit from World Bank AAA pricing, but the proceeds are dedicated to green projects that are monitored by the World Bank. Imagine the World Bank, or another development finance institution that raises money in the capital markets, issuing Social Development Bonds to fund social service providers, and particularly those providing preventive services or performance-based contracts, as they scale up. Would this be a better use of resources than those proposed by Professor Burand to adapt the SIB structure to the developing world?

The excitement surrounding SIBs is well deserved. The focus on prevention rather than remediation, the confluence of capital markets and philanthropy to fund social services, and the added rigor the model brings to government contracting are all welcome. To the extent that the enthusiasm for early SIBs has been a catalyst for legislative changes that permit governments to contract for vital social services on a pay-for-success and multi-year basis, the SIBs have already had a positive effect. However, before choosing a SIB structure, careful thought should be given to alternative innovative financing techniques that may be able to achieve the same goals more efficiently and more effectively.

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17. *World Bank Green Bonds*, WORLD BANK TREASURY (2009), *available at* http://treasury.worldbank.org/cmd/htm/WorldBankGreenBonds.html.