The Potential for
Social Impact Bonds
in New Zealand

A report prepared for the Department of Internal Affairs

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Executive Summary

This report explores the nature of Social Impact Bonds (SIBs) and identifies policy and market constraints to their extensive use. It provides a strategy that focuses on the key steps required before a comprehensive assessment can be made as to whether SIBs should be trialed in New Zealand.

A SIB is a specialist mechanism that falls within the ambit of Social Financing. The key features of SIBs are:

- Are a contract between the government and private investors, usually through a bond issuing intermediary (referred to in this report as “Broker and Contract Manager”);
- The contract is for the delivery of improved social outcomes to a defined group of people;
- The Broker and Contract Manager obtain funds from private investors to achieve the improved social outcomes. In exchange, the investors receive bonds;
- The investors can cash in their bonds and achieve a return on their investment only if the contracted for social outcomes are achieved. If the performance targets are not achieved, the government does not pay.

The key advantages of SIBs over current approaches to social policy are that they offer the opportunity to introduce new, private money, into social programmes without increasing public debt and without the need to decrease existing spending. Investors are paid based on the level of social value that is delivered. This leads to a process of constant monitoring of the success of the project, strong incentives to identify and change poor performing programmes and the encouragement of innovation. The financial risk of the project failing is transferred to the private sector. SIBs also provide an incentive to allocate expenditure on preventative, rather than “crisis”, projects, as this is where the greatest returns on investment can be made.

There are significant public policy and economic difficulties associated with SIBs. From a policy perspective, there are very real difficulties in assessing what projects have the potential to deliver a net benefit for the government, and even greater difficulty in evaluating whether contracts are being successful or not (which is critical for determining the level of payment investors receive). From the market perspective, key features that make SIBs unattractive as compared with other investments are their low rate of return given the high risk associated with them, the likely inability to independently verify whether success has been achieved and their lack of liquidity.

None-the-less, SIBs are of interest to the social lender and philanthropist sector, as they are an additional finance tool and SIBs also provide the opportunity for social loans to be recycled, and financial risk and obtaining a financial rate of return are of lesser concern than to commercial investors. However, this sector is small in New Zealand, with limited collaboration between participants. Due to the high transaction costs associated with SIBs, the required scale of investment is likely to be challenging to the social lender and philanthropic sector.
Overseas, SIBs are evolving rapidly in design, and it is likely that within the short term they will change in nature or be overtaken by another financial instrument that is able to better blend the theoretical and real world issues. The overall strategy suggested for New Zealand is not to engage in trials or implementation of a SIB, but to obtain better understanding of the New Zealand investor environment, especially the social lender and philanthropic sector. In this way, as overseas experience and design options arise, New Zealand will be well placed with networks and information to adapt new designs for local conditions.

A series of specific steps are proposed in the report which are focused on building a relationship with the potential investor market, so that its perspective on the current limitations of SIBs can be identified. Even if SIBs do not prove viable in the New Zealand context, the lessons learned from overseas and the stronger relationships it is recommended that should be built between sectors, will improve the performance of public sector outcome based contracting.
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1. This report, prepared for the Department of Internal Affairs, explores the opportunities afforded by social financing and Social Impact Bonds (SIBs) in particular. It describes the nature of SIBs, their advantages and risks compared with existing mechanisms, and explores what sectors of the New Zealand market may be interested in investing in SIBs.

2. A strategy is provided that focuses on the key steps required before a comprehensive assessment can be made as to whether SIBs, or variations on them, should be trialed in New Zealand.

3. The report has been prepared after reviewing existing international literature and interviewing a number of New Zealand public policy advisers and market participants.
1. **A NEW APPROACH TO SOCIAL INNOVATION**

1.1 **Social Financing**

4. Social Financing is a concept in which investors seek to obtain a financial return by lending or investing in projects that advance social and environmental outcomes. The loans or investments have similar characteristics to fully commercial activities but are likely to operate at a higher level of risk and at a lower interest rate than commercial operators. In this way social financing can be said to sit between commercial loans and investment and charitable grants and donations.¹

5. The central feature of social financing is for investments to be assessed by evaluating social and environmental impacts alongside commercial returns. Europe and the US have experienced a rapid growth in this sector in recent years, with assets in US socially screened portfolios reaching US$3.07 trillion in 2010.² This represents a faster rate of growth than the conventional managed investments under professional management.³ In contrast, while New Zealand has had some development in the social financing market, it has been at far lesser rate than overseas.⁴

6. There are a number of distinct players in the social financing market, each placing a different emphasis on aspects of commercial return or social outcomes. An assessment of the potential of SIBs will need to consider the differing incentives and objectives of these players:

   - Social Enterprises – profit making business set up to tackle a social or environmental need, with the profit used to support social aims.⁵ In New Zealand they are often Incorporated Societies or NGOs that provide health or education services to government agencies⁶.

¹ Saunders p2
³ Ibid
⁴ Saunders p23
⁵ Canadian Charity Law
⁶ Sanders p17
• Social Lenders - private investment funds or businesses which make investment choices in order to maximise financial return with social good. They are strongly proactive around socially responsible investing with their overall aim being to make responsible saving and lending choices as their key objective. A New Zealand example is Prometheus Finance Ltd⁷;

• Responsible Investors – private or public investment funds or businesses which seek to exclude undesirable investments from their investment portfolio (often referred to as “negative screening”). For example, the NZ Superannuation Fund has a policy of ethical investing that takes account of human rights, labour, environmental and anti-corruption issues⁸;

• Philanthropists - foundations or trusts that provide funds to individuals or agencies for social benefit. This is usually but not exclusively by way of grant or donation, such as the various regional Community Trusts.

7. Social financing can be undertaken by a range of financial mechanisms, such as loans, loan guarantees, equity investments or complex financial instruments such as SIBs.

1.2 What is a Social Impact Bond?

8. A SIB is a specialist mechanism that falls within the ambit of Social Financing. The key features of SIBs are that they:

• Are a contract between the government and private investors, usually through a bond issuing intermediary (referred to in this report as “Broker and Contract Manager”);

• The contract is for the delivery of improved social outcomes to a defined group of people;

• The Broker and Contract Manager obtains funds from private investors to achieve the improved social outcomes. In exchange, the investors receive bonds;

• The investors can cash in their bonds and achieve a return on their investment only if the contracted for social outcomes are achieved. If the performance targets are not achieved, the government does not pay.

⁷ Prometheus Finance Ltd

⁸ New Zealand Superannuation Fund
9. The best known example of a SIB involves a contract signed in 2010 between the UK Government and a bond issuing agency in respect of former inmates of Peterborough Prison. The desired social outcome contracted for is to lower the reconviction rate for short sentence prisoners from the standard 60% by 7.5% as compared with a control group. The contract provided that payment would only be made if the 7.5% target was achieved, with investors receiving an increasing return for success rates above that amount, capped to a maximum of 13% per year over an 8 year period⁹.

10. The term “bond” is misleading, as that normally applies to a debt instrument in which the issuer is required to repay the debt and an agreed level of interest. In contrast, with a SIB all of the investor’s capital is at risk. Repayment of the capital along with a rate of return are only made if the social outcome is achieved.

### 1.3 Government can be slow to innovate

11. Overseas research indicates the proportion of social policy interventions dropped or amended by the government is small.¹⁰ There is no reason to assume New Zealand would be any different in this regard:

- Evaluation of initiatives is expensive, social projects by nature are lengthy, and techniques for undertaking evaluation are often uncertain;
- Initiatives once introduced are often costly to change; and
- There can be reluctance to trial new approaches especially in a tight fiscal environment, as the chance of failure is high, or if trials do work complex policy and political issues can arise.

12. In respect of outcome based projects, these factors can be expected to be exacerbated.

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⁹ Social Finance

¹⁰ Liebman p10
1.4 The advantages of SIBs over current approaches to social policy

13. Intuitively, SIBs would appear to be a more expensive means of funding government expenditure than standard borrowing options; investors are unlikely to engage in a SIB contract unless they are likely to succeed in delivering the defined outcome and then the government must pay the investor at a higher rate of return than the government itself could have borrowed the finance.

14. There are significant advantages that a well-designed SIB can, however, deliver over current approaches. These are:

**Outcomes not service delivery**

15. As SIB investors are paid based on achievement of the social value ("outcome") that is delivered, investors have strong incentives to focus on results and performance. This leads to a process of constant monitoring of the success of the initiative, strong incentives to identify and change poor performing programmes and the encouragement of innovation.

16. In contrast, input, output or service contracts focus on delivery of certain services or goods, but do not focus on the effectiveness of those services or goods at achieving a desired goal. Payments are made on the basis of costs borne by the provider, rather than on performance.\(^{11}\) Such contracts encourages the public agency to focus on the cost of services rather than the value delivered and can create incentives for the provider to be more efficient in delivery, without considering the desired outcomes.\(^{12}\) This insufficient focus on value delivered means that unsuccessful programmes can persist for years.\(^{13}\)

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\(^{11}\) Liebman p9

\(^{12}\) Bolton and Savell p14

\(^{13}\) Liebman p7
**GOVERNMENT PAYS ONLY FOR SUCCESS - TRANSFER RISK TO THE PRIVATE SECTOR**

17. The amount the government pays the investor is directly related to the value of the social benefit delivered – if no social value is obtained no payment is made.\(^{14}\) Conversely, the greater the success of the project the higher the payment to the investors. In addition, SIBs involve transfer of the risk of failure to the private sector, which delivers financial and political benefits to the Government.\(^{15}\)

**FUND PREVENTATIVE SOCIAL POLICY PROGRAMMES WITH NEW (PRIVATE) MONEY**

18. Governments often face political pressure to fund “crisis” issues, while allocating funds for preventative initiatives that do not deliver immediate results proves more difficult.\(^{16}\) SIBs provide an incentive to allocate expenditure on preventative, rather than crisis, projects as this is where the greatest returns on investment can be made. It is therefore possible to introduce new, private money, into social programmes without increasing public debt and without the need to decrease existing spending. Overtime, SIBs could prove an effective way to reduce public expenditure because preventative interventions are generally cheaper than tackling problems.\(^{18}\)

**CREATES INCENTIVES FOR COLLABORATION BETWEEN SERVICE PROVIDERS**

19. Because SIBs reward success in achieving social outcomes, there are strong incentives for collaboration between a range of service providers. For example, in respect of an SIB for introducing young people into jobs, collaboration may be required between experts in literacy, drug management, and mental health. Collaboration is more difficult to achieve with output service providers or public sector providers\(^{19}\) and it may take years to

\(^{14}\) Bolton and Savell p19

\(^{15}\) Mulgan and Reeder p16

\(^{16}\) Bolton and Savell p11

\(^{17}\) Mulgan and Reeder p11

\(^{18}\) Bolton and Savell p10

\(^{19}\) Ibid p18
successfully breakdown departmental silos. SIB investors have strong incentives to identify and undertake collaboration opportunities if this will help achieve social outcomes - as without success their capital is at risk.

1.5 What SIBs can be used for

20. A SIB contract needs to be both outcome based and preventative in nature. These are the elements that distinguish SIBs from contracts that Governments often have for the provision of services or outputs. Once the focus is on results rather than services, opportunities are opened for the investors to share in the financial returns by bringing innovative and more successful approaches to improving social well-being.

21. SIBs must also be focussed on a clearly defined population group. This element is necessary because of the need to assess the success or failure of an intervention programme.

22. While few SIBs have been trialled world-wide, various studies have explored the type of social policy programmes that may be suitable for SIBs. A selection of those identified as potentially suitable for SIB are outlined below:

- Adult reoffending;
- Preschool readiness;
- Reading skills in disadvantaged communities;
- Employment services for hard-to-employ groups;
- Homelessness;
- College retention services;
- Providing support for disabled or elderly to stay in their own homes;
- Health prevention for certain conditions (e.g. multiple sclerosis, mental health).

20 Andrew Waa, MSD discussion with author 16/9/11
21 Liebman p27
22 Mulgan and Reeder p23-27
23. Whether or not a programme is in fact suitable for a SIB approach at a specific location, must be assessed against factors discussed in the next two sections of this report. It should be noted that a programme suitable in, say the UK, may prove not suitable for an SIB approach in New Zealand (due, for example, to the different way government funding is split between local and central government in the two countries).²⁴

²³ The Centre of Social Impact p.8

²⁴ Treasury discussion with author 14/9/11
2. HOW TO BUILD A SOCIAL IMPACT BOND

2.1 SIBs have no standard model

24. SIBs exist almost predominantly in the academic literature, with the first being trialled in the UK in 2010, a trial is now proposed in Australia and notably no trials have yet been undertaken in the US (although funding for research has been allocated). Not surprisingly, for such a new instrument, differing approaches have been suggested for SIBs, with the UK and Australian trials having some important differences in their design features.

25. One factor that influences key aspects of SIB design is who is providing the investment funds. Different sectors of the funding market will be prepared to carry differing levels of risk and will seek different rates of return. If SIBs are funded entirely by the commercial sector, full risk transfer away from the government is unlikely to be accepted and a high rate of return would be expected. In contrast, funding by the philanthropic sector may provide for full risk transfer and possibly a low rate of return.

26. In New Zealand (as has been concluded overseas) a hybrid approach, blending different sources of funding, would be the most likely model used. This would mean that any SIB trial carried out in New Zealand would have significant differences to the UK Peterborough Prison trial, particularly with respect to contractual payment and assessment provisions.

2.2 The structures needed for SIBs

27. At least three different operational structures have been developed for organising the functions and roles required of a SIB system. An assessment of the different designs is

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25 Centre of Social Impact p8
26 Langford p3
27 Mulgan and Reeder p9
28 Ibid pp10-12
not necessary for this report, but a generalised example is outlined below in order to give a visual representation of the necessary elements.

28. The key elements illustrated below are:

- The **Government** contracts with a **Broker and Contract Manager** for the required social outcome. The **Government** pays the **Broker and Contract Manager** on successful completion of the contract;
- The **Broker and Contract Manager** collects funds from **investors** and in turn issues bonds to the investors. The **Broker** also oversees the management of the services provided by **Sub-contractors**;
- **Sub-contractors** provide specialist services (such as literacy support, drug management) to achieve the contracted for social outcome;
- **Investors** may sell bonds on the secondary market.
2.3 The three key steps needed to build SIBs

29. The following key steps are needed to implement individual SIB proposals. Policy challenges that arise with each of these steps are discussed in the next section of this report.

**Select an outcome that is preventative**

- Select a social outcome rather than a service or output;
- Be preventative in nature (“fence rather than ambulance”);
- Select a clearly defined treatment population (needed to evaluate success for payments).

**Undertake analysis and modeling of proposal**

- Obtain evidence that proposed interventions have likelihood of success;
- Select a programme where failure will not result in excessive harm to the target population;
- Develop an objective measurement of proposed interventions, preferably using a control group;
- Ensure success of social outcome will significantly exceed costs;
- Ensure the cost savings will accrue to the Government.

**Negotiate contract and confirm Government preference**
• Agree contract with Broker and Contract Manager for desired social outcome;
• Obtain Government agreement, demonstrating expected level of success and the nature of key risks. Outline an approach to achieve understanding and acceptance of programme with the public.

2.4 Focus on analysis of proposal and measurement of success is critical

30. The analysis of the proposal and its actual performance is perhaps the most critical and complex area to achieve the successful application of SIBs. The bulk of academic literature on SIBs is devoted to discussing and attempting to address difficulties in this area. Measurement of both the forecast and actual results provide challenges as issues of performance targets, cost and also rate of return need to be determined.29 The reasons for needing to have robust analysis and measurement are, however, far from academic:

For Government:

• Ministers will need a strong body of evidence that the proposal has a real chance of success;
• Savings from the contract must be large enough to fund the success payments for the investors;
• Ministers need quality information to assess if the risk of failure will not unduly harm the targeted population.

For Government and Investors:

• Contracts will need to contain objective measures, that can be independently verified, as to whether the project is succeeding, as this is the basis for making payments, or declining to make payments to the investors.

For Investors:

29 Liebman p15
Provide confidence to the investor market that the SIBs are robust tools that are not inherently flawed due to poor or ill developed payment criteria.

3. Why SIBs are not widely used

3.1 Proposed SIBs must show benefits for the Government

31. Officials need to be able to generate a strong body of evidence to demonstrate to Ministers that the proposed project has a real chance of success. The research required is both time consuming and expensive, potentially reducing the viability of an SIB approach. Indeed, this aspect of identifying suitable projects with sufficient net benefit has been said to be the biggest obstacle for advancing SIBs.30

32. If a small trial has been used to gather evidence, the literature suggests that trials or roll-out of smaller programmes often do not achieve expected results.31 To avoid some measurement difficulties, it is often suggested that a control group be used for comparative assessment; but it is often unrealistic to assume the targeted population can be isolated from other influences or that a fair control group could be identified.32 Care must also be taken that the selected indicators do not create opportunities for perverse behaviour33 or data manipulation34 by the contractors. To mitigate these factors an independent evaluator of the performance of the contract is often suggested,35 and while positive, such a step will not be able to overcome problems arising from a contract that by its nature cannot be independently verified.

33. When undertaking the assessment of financial savings, only direct savings to the Government can be taken into account. This means that:

30 Liebman p18
31 Mulgan and Reeder p17
32 Ibid p18
33 Bolton and Savell p32
34 HM Cabinet Office “Early Intervention” p48
35 Liebman p15
Broader social benefits that are delivered to individuals or the community generally cannot be accounted for, as those savings are not made available as cash savings to the government.\textsuperscript{36} Without the savings, the government is unable to fund payment of the investors. For example, an intervention that leads to an improved quality of life should not form part of the cost-benefit analysis;

- Savings that have no impact on fixed costs similarly cannot be accounted for.\textsuperscript{37} For example, reducing prisoner recidivism or patient intakes may only deliver marginal benefit, until the level of success is reached when a prison or hospital wing can be shut down or need no longer be constructed.

### 3.2 SIB PROJECTS MUST BE ATTRACTIVE TO INVESTORS

34. Whether SIBs are attractive to investors depends on the rate of return that it generates. Not all of an investor’s SIBs can be expected to succeed, but this risk could be spread by an investor holding a portfolio of smaller SIBs over several projects.\textsuperscript{38} Even so, the rate of return for those that do succeed needs to be high enough to cover the loss of both the principle and return on failed projects.\textsuperscript{39}

35. Investing in SIBs is a high risk market – both because of their novelty and the uncertainty of success of innovative initiatives, but also because of the potential impact that secondary effects (that are out of the control of the investor) is likely to have. Investors as a rule only accept risk in areas they have control over, where they can influence the outcome, and are able to manage their exposure.\textsuperscript{40} In such an environment, investors would need to have regular intermediate indicators of performance, such as yearly Key Performance Indicators (KPIs).

\textsuperscript{36} Bolton and Savell p35
\textsuperscript{37} Ibid p36
\textsuperscript{38} Liebman p20
\textsuperscript{39} Ibid p19
\textsuperscript{40} HM Cabinet Office “Early Intervention” p45
36. Social benefits can be expected to take years to emerge; perhaps 5-10 years is realistic.\textsuperscript{41} This means that the ability of an investor to exit an SIB and invest elsewhere would be important, and therefore a secondary market in SIBs is necessary so that investors can on-sell to other investors. It also means the rate of return must be high enough to accommodate the lengthy timespan of SIB contracts, with longer contracts requiring increasing rates of return.

37. Each of these factors is explored in greater detail in respect of their application to the New Zealand market in the next section.

### 3.3 Contracts will contain uncertainty

38. Contracts between the Government and the Broker and Contract Manager need to have a clear definition of the social outcome that must be achieved and contain an objective measurement process for the purpose of assessing performance. It must also contain financial issues such as risk/return and variation of repayments with level of success.\textsuperscript{42}

39. As is the common experience internationally, New Zealand departments that seek to develop outcome or performance based contracts, find the means of measurement and selection of indicators particularly troublesome. Selection and measurement of outcomes is complex. Many technical, statistical and academic issues arise with developing robust measurement, not least of which is making fair allowance for unexpected second order effects. For example, a SIB contract for reducing recidivism may have proved successful, but for a downturn in the economy. This impact, uncontrollable by the investor, would result in the loss of both their capital and any success payments. The reverse of this could also occur, with an otherwise poor performance by the contractor leading to the Government needing to make success payments.

40. The experience of some departments in respect of developing performance or outcome based contracts is outlined in the next section of this report. Even with well-developed outcome based contracts, investors may incur considerable costs in analysing and discussing the interpretation of results (on which their payment is dependant), especially if results depart (even positively) from forecast results.

\textsuperscript{41} Mulgan p9

\textsuperscript{42} Mulgan p41
41. The negotiation and interpretation of contractual documents is the main driver of the disproportionately high transaction costs faced by output or performance based contracts. Increased learning and knowledge around the issues associated with selecting and implementing indicators (such as how they can be affected by uncontrollable impacts or manipulated by contractors), has only increased the challenge of drafting legally binding contracts. If defined outcomes are evaluated using complex metrics, then contract drafting becomes more complex. This suggests a growing need for enhancing public sector capability in drafting and managing contracts, with perhaps some lessons to be learnt from the private sector.

3.4 An immature market

42. The lack of a track record with SIBs is a major deterrent for potential investors. Investors are always interested in the potential for new financial assets in the market, but there is little incentive for any investor to move first where so many risks and uncertainties exist:

- Evaluation of contracts is subject to uncontrollable impacts;
- There is high risk on not achieving the rate of return;
- With trials, risk cannot be spread between a portfolio of projects;
- SIBs are for lengthy periods and there is no secondary market in them.

43. A further feature of the immature market is the lack of any current parties that could undertake the crucial role of Broker and Contract Manager. That role is multi-faceted and complex, particularly as it requires the ability to straddle the government, financial and social provider environments. As illustrated in the diagram in section 2, Brokers and Contract Managers undertake the key roles of:

- Collecting funds from investors and issuing them bonds in return;
- Contracting with the Government for the social benefit; and
- Managing the contract, probably by subcontracting with service providers, such as with alcohol, literacy and health experts.

44. The role requires knowledge of each environment, extensive networking skills and understanding of the language, perspectives and political drivers of each environment. In New Zealand, some institutions are developing the capability and knowledge to be able to straddle one of these sectors (such as service providers contracting with the government, or social lending companies with investors) but no examples have been identified that undertake the full range.
3.5 Public perception

45. A further constraint of a more political nature is the lack of public understanding and acceptance of outcome based initiatives, and a perceived caution for private involvement in social policy.
**4. What experience does New Zealand have with outcome based contracts?**

46. There have been no SIB trials in New Zealand, and most government experience with contracts have been in managing for outputs and services. The requirement for departments to define their activities in terms of outcomes and to undertake regular assessment of their success was only introduced into the Public Finance Act in 2005.\(^{43}\) This task has proved difficult for policy based departments, in particular, and capability is still evolving.\(^{44}\)

47. Various departments or agencies have gained experience with outcome based contracts, but building capability in the area of evaluation is acknowledged as being a “major priority”.\(^{45}\) There is value in reviewing their experience as some of the key challenges of outcome contracts are replicated, or exacerbated, with SIBs.

**4.1 The Department of Corrections**

48. The Department of Corrections has extensive experience of service type contracts and in more recent years with a Public Private Partnership, with a true performance based contract and with some variants.

49. Public Private Partnerships have many resemblances to a SIB as both involve collaboration between the private and public sectors where risk is transferred away from the government.\(^{46}\) However, SIBs have a marked distinction from SIBs, as SIB investors will only receive the return of their principal and a rate of return if the project delivers savings for the government.

50. Officials state that the Correction environment produces clear, numbers based data which lends itself to performance based approaches as evaluation of results is practicable. However, officials also state that evaluating how results were achieved is much more complex. There are strong incentives for contractors to “cherry pick” and the

\(^{43}\) Public Finance Act s.40

\(^{44}\) Treasury discussion with author 14/9/11

\(^{45}\) Bedford

\(^{46}\) Langford p37
Department has evidence of perverse behaviour by contractors. The transaction costs and hidden costs (of, for example, developing an effective relationship with overseas based company senior management) are high. These contracts are credited with bringing innovation and a global perspective to management and operational activities, but the financial benefits to the Department remain uncertain.47

51. The Department of Corrections has explored the concept of SIBs. The previously identified challenges around measurement and cash flow are seen as major constraints.48 As there is a lack of depth in the New Zealand Corrections sector, SIBs are considered to have potential to incentivise NGOs (who currently contract for provision of services to the Department) to pool resources, both in terms of contracting and in providing a holistic approach to achieve outcomes.49

4.2 New Zealand Transport Agency

52. The NZTA has most of its contracts for the maintenance of state highways defined on an outcomes basis. These contracts are long term, typically for 10 years, are contracted directly with the service provider and define the standard and performance required over time. The key outcome feature of these contracts is that the contractor has full discretion as to what maintenance is undertaken and when, provided the defined outcome is maintained. Equal payments are made according to a defined schedule.

53. NZTA consider the approach has led to innovative maintenance approaches, but note that incentives exist for perverse behaviours. The major difficulty has been defining the contracts adequately and taking account of the myriad of variables that can arise. To manage this, a Management Board for each contract has been established consisting of both Government and contractors to deal with uncertainties in the interpretation of the contracts and with disputes. After a decade of these contracts, a review is currently being undertaken to assess if they have resulted in financial benefit for the Government.50

47 Jane von Dadelszen, MSD, discussion with author 16/9/11
48 Ben Clark, MSD, discussion with author 16/9/11
49 Jane von Dadelszen, MSD, discussion with author 16/9/11
50 Richard Quinn, NZTA, discussion with author 12/11/11
4.3 Ministry of Social Development

54. The Ministry of Social Development has been working to define social outcomes for the Department as a whole and also in a series of projects with other social agencies. The objective of moving to outcome based approaches is to gain a better understanding of how well existing programmes are working, how they could be improved and to ensure that the Department is working towards achieving enduring results that are of relevance to the community as a whole. The Department has faced the same challenges with respect to outcome definition and measurement of progress that has been a common theme of this report, and considers all these aspects as “work in progress”.  

55. One of the main challenges of developing successful evaluation is to select effective indicators of success. In the past, programmes have been assessed by measuring volumes, such as the percentage of NCEA results, or numbers treated in health. For outcome assessment, there is a need to “reflect not only gains in a particular sectorial sense but gains that reflect the aspirations people have.”

56. The Department’s cross-departmental programmes are with departments such as Justice, Police, Education, Health and TPK. The Social Sector Trials, for example, are aimed at improving social outcomes for youth and are designed to delegate decision-making on the programmes to small rural communities. MSD considers there is real benefit to be achieved with cross departmental outcomes, as it enhances the prospects of departments together reducing identified social issues, creates incentives for the breakdown of silos, develops a common measurement approach and evaluation of trials, and results in more effective expenditure. The programmes have not proved easy, with the familiar issues of outcome definition, measurement and selection of indicators proving complex.

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51 Andrew Waa, MSD, discussion with author 16/9/11

52 Durie

53 Andrew Waa, MSD, discussion with author 16/9/11
5. Who would invest in SIBs in New Zealand?

5.1 Commercial Sector

57. SIBs are unlikely to be a practical instrument for the commercial sector. The commercial lender or investor seeks to maximise profit while minimising risk – these are features not consistent with SIBs. A recent Canadian study concludes “It would be impossible to entice private investment in to a social impact bond where outcomes and thus repayment are uncertain.”\(^5^4\) An Investment Advisor at the New Zealand Treasury has stated that if SIBs place capital and interest at risk, then “that would discourage most commercial investors because of the general skepticism around any success of social initiatives.”\(^5^5\) An authoritative US study concludes “If social impact bonds end up combining equity-like risk with bond-like returns, the market will be limited to philanthropic and socially minded investors willing to subsidize the achievement of social goals.”\(^5^6\) To date, trials of SIBs have been made attractive to lenders by either including Government subsidy (such as the often cited Peterborough Prison example), or by proposing to spread risk between the Government and investors (such as the NSW proposed trial). These features negate much of the benefit of SIBs from the Government perspective.

58. A recent report by the Association of Non-Government Organisations of Aotearoa (ANGOA) states there “has been a lot of interest particularly from those superannuation funds whose members require them to have social objectives in their mix of investments.”\(^5^7\) Interviews for this report with the Treasury officials, who liaise with the NZ Superannuation Fund and with ACC (which operate under an ethical but fully commercial objective), as well as having knowledge of the relevant private sector, did not confirm any such “strong interest” exists.\(^5^8\)

\(^{54}\) Langford p38  
\(^{55}\) Treasury official E-mail to author 26/9/11  
\(^{56}\) Liebman p28  
\(^{57}\) ANGOA  
\(^{58}\) Treasury discussion with author 14/9/11
59. The three major reasons for SIBs not appearing attractive to commercial lenders are:

- The rate of return is probably too low;
- Uncertainties in measuring success;
- Liquidity is poor.

These issues are discussed below.

THE RATE OF RETURN IS PROBABLY TOO LOW

60. Whether SIBs are attractive to investors depends fundamentally on the rate of return that it will generate, as compared with other investments. The interest able to be charged is linked directly to the risk faced by the investor. In general, unsecured venture capital carries very high interest costs, while (excluding government borrowing) secured property loans carry low-end interest charges.

61. The biggest driver of risk with SIBs is the uncertainty of the project achieving the contracted for outcome, as otherwise investors will lose their principal (and, of course, obtain no rate of return). A recent UK study found that the risk of losing the principal invested was considered by most investors as unacceptable, unless it was a philanthropic proposition.59

62. A second important factor with success rates is that governments must generate enough savings from a SIB contract to fund success payments to the investors. What then, is the likelihood of social well-being projects succeeding? Success rates for New Zealand performance or outcome based contracts are not readily available, but a US source reports NGOs who undertake performance based contracts claim a 30-40% success rate60. Research from the UK in the Criminal Justice sector indicates success is more in the 10-20% rate61, while US research suggests the internal rate of return delivered by

59 ClearlySo p87
60 Mulgan slide 19
61 Mulgan and Reeder p29
social programmes “are barely above the discount rate of 3 to 5% typically used in social impact evaluation”.62

63. Not all research is as negative about the ability of social well-being projects to generate savings of sufficient size to enable the government to pay back the original investment plus interest. However, even research with positive results concludes “prudence therefore suggests aiming at impacts in the 10%-20% range.”63

64. Investors would seek to spread this risk by investing in a portfolio of projects, with successful projects having a high enough rate of return to compensate for the unsuccessful projects. It has been estimated that with a high success rate of 90% of projects, an investor would require a rate of return of just less than 30%, while with 50% of projects succeeding, the rate of return required climbs to 70%.64 Such figures make SIBs impractical for commercial investment, as compared with average returns in the New Zealand venture capital market.65

**Uncertainties in measuring success**

65. A second major risk for investors is the uncertainty inherent in contracts on how success will be measured. This has been explored in the previous section, and contrasts strongly with the norm in commercial contracts. Even with insurance contracts, or the developing market of life settlement bonds, a high level of accuracy can be predicted and achieved.

**Liquidity is poor**

66. Liquidity, that is the ability to convert an asset (such as a bond) into cash, is an important element when assessing a potential investment. Contracts for social outcomes are most likely to be lengthy, say 5-10 years, meaning that individual investors will have their funds locked up for this period. In financial markets, liquidity is usually achieved by the bond holder being able to transfer or trade their bonds with other investors on a secondary market.

62 Liebman p19

63 Mulgan and Reeder p17

64 Ibid p35

65 NZ Private Equity and Venture Capital Assoc.
67. No such secondary market exists for SIBs and this would be a major constraint on investors being willing to invest in them.\textsuperscript{66} However, if a SIB market were to develop, over time a secondary market could be expected to emerge, without the need for Government stimulus or regulation.

\textbf{5.2 Social Lenders}

68. Social lenders tend to be companies that take deposits from NGOs, individuals, companies or foundations and invest them as loans only in programmes that have a social benefit. Matters of key importance in selecting appropriate programmes are “who” the investments are with, and “what” the investments are for.\textsuperscript{67}

69. This market is growing rapidly in Europe and some social lending institutions have reached considerable size; Triodos Bank for example is Europe’s largest social lender with a 2010 equity of NZ$1.2b.\textsuperscript{68} In contrast, the New Zealand social lending market is small, with few participants.\textsuperscript{69} The best know is perhaps Prometheus Finance Ltd, which has strongly promoted the social lending concept within New Zealand and achieved modest growth in recent years. In addition the Southland and Canterbury Community Trusts have been cited as including small scale social loans (usually of $20,000 to $50,000) as a small part of their overall activity.\textsuperscript{70} Research by Sanders could not identify any social lending being undertaken by iwi or Maori Incorporations, as their loan activity was on a commercial basis in order to maximise returns, and then advancing social goals through grants or self-investment in community facilities.\textsuperscript{71} Ngai Tahu has, however, recently undertaken research into social lending.\textsuperscript{72}

70. Current New Zealand participants in this sector have indicated that there is considerable interest in the concept of social lending and assess there is room for growth. This is

\textsuperscript{66} ClearlySo p88
\textsuperscript{67} Sue Cooper, CEO Prometheus, discussion with author 15/9/11
\textsuperscript{68} Triodos Bank
\textsuperscript{69} Benedict p.vii
\textsuperscript{70} Sanders pp 17-18
\textsuperscript{71} Ibid p20
\textsuperscript{72} Ngai Tahu E-mail correspondence to DIA 8/9/11
despite social benefit investors receiving a return that is around 1% below market and to date there has been limited demand from borrowers.

71. SIBs offer a challenge for the social lenders that is considerably greater than social lending itself. The level of financial risk is much greater, the novelty of the instrument creates caution and its complexity, which is not well understood, makes it a bridge too far for social investors - who are operating in a social finance market in its early stage of development. While social lenders have expressed interest in SIBs, it is perhaps more with an eye to watching their development from afar. The CEO of Prometheus Finance Ltd has stated that “there is a real danger that bringing new and complex instruments to the market at this stage will create confusion and hinder the development of social finance in New Zealand.”

5.3 Philanthropists

72. There are a number of foundations, trusts or statutory entities in New Zealand that provide funds to individuals or agencies for social benefit. This is usually by way of grant or donation, with the best examples in New Zealand being Community Trusts, the New Zealand Lotteries Commission, the Tindall Foundation, McKenzie Trust and the Todd Foundation. In 2005/6 the size of giving by the philanthropic sector was estimated at NZ$1.27 billion, with about 35% of this comprising donations and bequests from individuals. Of the activities supported, culture, sports and recreation received 27% of funds, education and research 24%, social services 16% and health 10%.

73. Because agencies in this field have focussed almost exclusively on grants, they have not sought a return on their investment, or even the return of their principal. As a result, they are potential participants in the social lending and SIB markets. The CEO of the ASB Community Trust has confirmed the Trust has this interest but points out that the bulk of those who receive grants are reliant on this funding for their activities. They could not

73 Sue Cooper, CEO Prometheus, discussion with author 15/9/11
74 Saunders p23
75 Sue Cooper, CEO Prometheus, discussion with author 15/9/11
76 Sue Cooper, CEO Prometheus, E-mail correspondence with author 27/9/11
77 Slack p25
78 Ibid p38
take on a loan, even without an interest component, as they do not generally have an income stream.\textsuperscript{79}

74. The scale of required investment is a constraint for philanthropic investors seeking to enter the SIB market. In the UK most PFIs under £25m turned out to be uneconomic due to the transaction costs involved.\textsuperscript{80} A British study thought the minimum scale for SIBs may be similar.\textsuperscript{81} No evaluation of minimum economic scale has been undertaken for New Zealand, but smaller investors may be unable to meet the minimum economic scale and they are unlikely to be able to sustain the long period before payment is received under SIB contracts. A proposed NSW trial (which relies on collaboration between philanthropists and the State government adopting a significant level of financial risk) suggests AU$5-10m could be raised from investors.\textsuperscript{82}

75. Some receivers of philanthropic grants and donations do generate an income stream, such as grants made to sports stadiums, theatres or Community Economic Development Groups. Community Trusts have explored the potential to provide social loans that do not contain an interest component, as a way of making the Trusts’ funds go further. There is a strong incentive for philanthropists to find more effective ways of supporting community funding, as, for example, 70% of applications for support to the ASB Community Trust will be rejected for lack of funds.\textsuperscript{83} Social loans and SIBs would allow philanthropic funds to be “recycled”, with repaid loans and investments being relent and reinvested.\textsuperscript{84} There may be reluctance, however, to the use of limited funds on social projects that are perceived by some philanthropists as being the responsibility of the government.\textsuperscript{85}

76. The potential for social lending by the philanthropic sector is well recognised, but as yet very limited social lending occurs. The CEO of the ASB Community Trust considered that an eventual target of around 30% of funds being distributed through social loans, rather than grants, would make a substantial difference to the effectiveness of the sector.

\textsuperscript{79} Jenny Gill, CEO ASB Community Trust, discussion with author 16/9/11

\textsuperscript{80} Mulgan and Reeder p6

\textsuperscript{81} Ibid

\textsuperscript{82} Centre for Social Impact p27

\textsuperscript{83} Jenny Gill, CEO ASB Community Trust, discussion with author 16/9/11

\textsuperscript{84} Benedict pvii

\textsuperscript{85} ClearlySo
But before loans could be made, some complex issues arise for philanthropic lenders. For example, a community trust must be willing to foreclose on a community group which failed to repay its loan, for without such a policy loans are likely to be perceived more in the nature of a grant.

77. Philanthropists in New Zealand are also aware of SIBs, and consider them to be an “exciting” instrument with potential. They have been considered by both the Tindall Foundation and Community Trusts. At this stage, however, such agencies are focused on evolving the social lending market and SIBs are perceived as promising but requiring further development.

86 Tindall Foundation website
6. MOVING TOWARDS SIBs IN NEW ZEALAND

6.1 SIBs ARE NOT A PRACTICAL OPTION IN THE SHORT TERM

7. The research undertaken for this report leads to the conclusion that SIBs are perceived by a section of the market as an exciting idea - but that significant issues must first be addressed before even a trial is viable in New Zealand. These issues relate to both policy and commercial constraints.

POLICY

8. The most significant policy issues are:
   a. Knowledge needs to be gathered from potential investors on what they perceive to be barriers to investment in SIBs and how their preferred solutions would impact on public policy and government financial risk;
   b. Social lenders and philanthropists are likely to be key players, but greater collaboration and pooling of resources would be necessary for the scale of investment required of SIBs and the transaction costs involved. Are there legal or regulatory issues that inhibit such collaboration?
   c. More robust knowledge and skills need to develop within the public sector on crafting outcome-based contracts, and identifying in a cross agency approach, preventative, long-term projects suitable for investment. It is also necessary to enhance capability around evaluating whether outcome-based contracts, once implemented, are successful or not.

MARKET

9. Key issues in respect of the market are:
   • Without a level of government guarantee or subsidy, SIBs are likely to be attractive only to the philanthropic and to some extent to the social lender sector of the market;
   • Lack of robustness in measuring contractual success, illiquidity, necessary investment size and full transfer of risk from the government would probably remain issues for the philanthropic and social lender sector (but to a lesser extent than for commercial investors);
The novelty of the instrument, its complexity and the limited networking and relationships that currently exist between Government/Service Providers/Investors imposes a significant barrier to further developing SIBs.

6.2 Despite these limitations, SIBs remain attractive to Governments

10. SIBs continue to attract the attention of policy makers and governments; the US has recently allocated US$100m\(^87\) for research and implementation and the UK Government is assisting the further development of SIBs by announcing the establishment of the Big Society Capital. While the bank is designed to assist in social investment in a variety of ways, especially in leveraging new finance into the growing social investment market, it “will invest in products developed by intermediaries and encourage others to do likewise”\(^88\).

11. SIBs are a logical progression from outcome based contracting and have the major attraction in a tight fiscal environment of allowing additional expenditure on social well-being projects, without increasing public expenditure. They also focus attention on preventative, rather than crisis, projects as this is where the greatest returns on investment can be made.

12. None-the-less fundamental difficulties remain unresolved with SIBs. Some of the difficulties are inherent in the nature of the instrument itself, such as the level of risk that investors must shoulder, or the inability of contracts to define measurement (and therefore payment) criteria adequately. To “overcome” these matters, governments or policy makers have proposed to avoid or mitigate the impacts by, for example:

   a. Creating or amending tax incentives\(^89\);
   b. Redesigning SIBs so that not all the financial risk is transferred to the investors\(^90\);
   c. Providing partial government guarantees\(^91\);

\(^87\) HM Cabinet Office p8
\(^88\) Ibid.
\(^89\) Philanthropy UK p15
\(^90\) Centre for Social Impact p9
d. Assisting growth in the market by establishing a funding source (the Big Society Capital).

13. A number of these mitigating policy tools serve to undermine the core benefits of SIBs from the government’s point of view. Some, such as the provision of guarantees can be designed so as to retain some benefit for the government; the higher the level of risk retained by the government the lower the required level of reward payment. Most of these mitigating policies (and others besides) are unlikely to be viable options for New Zealand, but participants in the sector have suggested such mechanisms are worthy of investigation in New Zealand. What they do illustrate, however, is the growing knowledge on the practical operation of the previously academic concept of SIBs. They focus on the areas that are now understood as being the barriers to the acceptance of SIBs into the market. But the nature of the policy “patches” proposed suggest further product design needs to occur.

6.3 A STRATEGY FOR NEW ZEALAND

14. SIBs are still in their early stage of design and testing. In theory they are an exciting financial instrument with the potential to revitalise social policy delivery and inject private sector funding and innovation into the sector. At this stage of their development their attraction to investors, even with government subsidy and assistance, is dependent on socially-motivated investors.

15. The size of the socially-motivated investor market (social lenders and philanthropists) has been explored in section 4 of this report. The sector is small, with the most innovative players currently focussed on developing their knowledge and experience of social lending. While key players in the sector are aware of SIBs, there is a desire to watch developments and assess opportunities for the future.

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91 Ibid p38
92 Ibid p37
93 Treasury officials discussion with author 14/9/11
94 Sue Cooper, CEO Prometheus, E-mail to author 26/9/11
95 Bolton and Savell p24
16. SIBs are evolving rapidly in design, and it is likely that within the short term they will change in nature or be overtaken by another financial instrument that is able to better blend the theoretical and real world issues. The overall strategy suggested for New Zealand is not to engage in trials or implementation of a SIB, but to obtain a better understanding of the New Zealand investor environment. In this way, as overseas experience and design options arise, New Zealand will be well placed with investor and contractor networks and information to adapt existing designs for local conditions.

17. To achieve this strategy it is suggested the Government:

**IN RESPECT OF THE POTENTIAL INVESTOR MARKET (PARTICULARLY WITH LARGER SOCIAL LENDERS AND PHILANTHROPISTS)**

Develop a relationship with a view to building investor confidence in the government by:

- Exploring the barriers to their investment in larger scale projects and their preferred type of investment mechanism;
- Understanding their goals with respect to rate of return/risk with respect to social investments;
- Obtaining increased confidence in the ability of the government to draft independently verifiable contracts;
- Enhancing use of a common “language” and reduce indirect barriers to investment;

**IN RESPECT OF THE COMMERCIAL FINANCIAL SECTOR AND FINANCIAL ADVISERS**

Develop a relationship with a view to:

- Encouraging good product design, that addresses the issues of:
  1. Rate of return/risk;
  2. Liquidity;
  3. Assessment of success evaluation;
  4. Investment size.
IN RESPECT OF GOVERNMENT POLICY MAKERS

- Monitor overseas trials and literature on SIBs;
- Develop a work programme for developing the relationships outlined above in order to acquire the knowledge to assess whether in the future SIBs or a related instrument are viable within the New Zealand context and, if so, to design an instrument suitable for local conditions;
- Assess whether review is justified of legal and regulatory issues surrounding the organisational form of philanthropic structures.

18. The above strategy recognises the potential SIBs have to transform the way social well-being is funded and delivered - but it also suggests a cautious approach be taken so that the new concept can further evolve.

19. If SIBs prove not to be viable in the New Zealand context, then the policy initiatives suggested, and the building of relationships with the financial and philanthropic sectors, will provide the opportunity for enhancing the performance of public sector outcome-based contracting, and could better focus social policy on preventative, longer term, projects.
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