Frequently Asked Questions: Pay for Success/Social Impact Bonds

The movement toward outcomes-based financing—including Pay for Success arrangements—is gaining rapid momentum as demand for social services rises. Exploration of these financing mechanisms is expanding the pool of resources available to social service providers that deliver measurable results to the individuals, families and communities they serve. Pay for Success agreements and Social Impact Bonds stand out as innovations in the way we finance and scale programs that address critical issues.

This document explores Frequently Asked Questions that currently surround Pay for Success arrangements. As a nascent but growing field, there is emerging data and experiences that continually inform a better understanding of which practices work and which practices need to be discarded or refined. We hope that this document will spur further discussion and invite feedback.

1. Is there a difference between Pay for Success (PFS) and Social Impact Bonds (SIB)?

These terms are often used interchangeably. When the Social Impact Bond was first introduced in the United States, it was called Pay for Success and the terms were used synonymously. However, there is growing consensus that "Pay for Success" encompasses a broader umbrella of outcomes-based funding arrangements, while Social Impact Bonds are one among many potential ways to finance Pay for Success contracts.

In **Pay for Success funding arrangements**, a "back-end payor"—such as a government, foundation, hospital system or insurance provider—contracts with a service provider, or multiple providers, and agrees to pay for specific outcomes the service provider/s achieve. (Outcomes-based funding is a departure from the typical approach of paying service providers based on the amount of work they do—e.g., for the number of nights of shelter provided.) These outcomes contribute to a positive result desired by the back-end payor, such as reducing chronic homelessness. "Successful delivery" is measured by outcome targets, spanning a multi-year period, that have been pre-determined prior to project launch.

Social Impact Bonds are commonly understood as a financial tool that provides upfront funding for Pay for Success agreements. Private investors—commercial and philanthropic—provide the upfront capital needed to fund service delivery, and the back-end payor only repays these investments if targeted outcomes (defined at project launch and measured by an independent evaluator) are achieved. In this way, private investors bear the risk of the program at the center of the arrangement creating the target outcomes. Governments have used Social Impact Bonds to ensure that as the back-end payor, they spend taxpayer dollars only on proven results.

The current difficulty in distinguishing the two terms is partially due to the evolving definition (and creation) of other financing arrangements beyond Social Impact Bonds that fall under the Pay for Success umbrella. Examples of alternate Pay for Success arrangements may include outcomes-oriented performance loans and performance-based contracts. Below, we generally refer to "PFS/SIB" together. However, when used separately, we intend PFS to refer to outcomes-oriented contracts and SIB to refer to specific financing arrangements with upfront funding provided by private investors.

2. Where are PFS/SIB projects in the U.S.?

As of December 2014, seven projects have been announced in the United States:

In 2012,

- New York City announced the first U.S. project aimed at reducing youth recidivism.

In 2013,

- The State of New York began a project to support workforce development and reduce recidivism.
- Salt Lake County, Utah undertook a program to expand early education.

In 2014,

- The Commonwealth of Massachusetts launched a project to support workforce development and reduce recidivism for young adults.
- The City of Chicago announced a project to increase the provision of pre-kindergarten.
- Cuyahoga County, Ohio announced a project to address homelessness and improve child welfare.
- The Commonwealth of Massachusetts announced an agreement to reduce chronic individual homelessness.

In 2015, new projects are expected to launch in California, Ohio, South Carolina, Illinois, Michigan, Colorado, New York, Massachusetts, Connecticut, and Washington DC. The UK has 16 projects underway and projects have launched or are developing in Canada, Australia, Mexico, Brazil, and India, among other countries.

3. What are appropriate issue areas for PFS/SIBs?

PFS/SIBs work best in funding preventative or early intervention programs, particularly those with measurable outcomes and high levels of empirical evidence. To date, PFS agreements have focused predominantly on early childhood education and recidivism. Additional projects focused on child welfare, mental health, housing, maternal/child health, and chronic disease management are developing across the country. These areas share a common denominator in that, if the outcomes sought are achieved (e.g., if recidivism is reduced), future expenditures (e.g., re-incarceration) can be avoided and cost savings can be generated. In the transactions to date, these arrangements have been designed to generate outcomes within five to seven years.

4. Do we know if the PFS/SIB models actually work yet?

This is the big question. While there are over a dozen projects underway and many more in development, no individual project has yet come to the end of its investment term. There is room for both optimism and skepticism with the interim project results. For example, the first SIB launched in the UK around the Peterborough Prison did not achieve its first year target outcome of a 10% reduction in recidivism for prisoners who received services, relative to a control group. This, in turn, did not allow for investors to receive the first interim project repayment. However, with the 8.4% reduction that was achieved, the project is on track to reach the two-year target of a 7.5% reduction in recidivism, which would trigger repayment to investors.

Additionally, there are other promising SIB results, such as an Australian project that is on track to reduce foster care utilization and pay out to investors as planned.

There is an opportunity to learn from these first projects and make adaptations. For example, in some US projects, philanthropic investors are now providing grant funding to support pilot projects or the first year of program implementation. This is particularly useful in cases where program referrals and service delivery involve multiple partners who may not have worked together in the same way in the past. In these cases, philanthropic capital can support adaptation on the part of all players as they pioneer a new way of working together.

These first Pay for Success agreements represent new ways of paying for social services that are ultimately aimed at reducing the costs associated with meeting critical needs by addressing problems early and effectively. We should expect both successes and failures as par for the course in a new field, and learn from both.

5. What are the opportunities and challenges for service providers?

Thoughtfully structured Pay for Success and Social Impact Bond contracts, in which multi-year, upfront funding is provided by private investors and outcomes targets are defined at project launch, can benefit service providers by:

- focusing all stakeholders on the primary objective of the involved service providers – delivering the best results possible for the individuals and communities served;
- providing a rare opportunity for upfront multi-year funding and removing the financial burden of fronting the cost of service delivery that traditional pay for performance contracts place on service providers;
- reflecting the true costs of delivering social services; and
- giving service providers the opportunity and resources to "course-correct" as needed through periodic assessments that ensure the ultimate goals of the PFS contract are reached.

A central challenge is that Pay for Success agreements are often designed to help successful programs scale and expand services. While this can further an organization's mission, growth is inherently risky and potentially destabilizing for providers if the full cost of operation and expansion is not funded. It is important that nonprofits fully understand their current financial and operational situation, in addition to organizational needs and constraints, before exploring PFS projects that necessitate growth or scale.

6. What qualities position service providers to successfully engage in PFS/SIB contracts?

A service provider needs to:

- be well-established and well-regarded in the community they serve;
- have demonstrated administrative and technical capacities to track and apply data toward continual program improvement;
- be prepared to engage in rigorous outcome evaluation;
- understand the full costs of delivering its services;
- appreciate the operational, reputational, and financial implications of being involved in the PFS/SIB market; and
- have the ability to clearly communicate to its board and funders the value-added, from a mission perspective, of participating in a PFS/SIB transaction.

7. **Are service providers who aren't well suited to PFS agreements at risk of losing funding?**

Many causes or organizations dedicated to good and important work have outcomes that cannot be measured under the terms of these structures. It remains to be seen if and how philanthropic funding may shift as a result of opportunities to fund Pay for Success efforts, and how the potential for systems-wide benefit may impact non- participating service providers. Funders and governments will be better positioned to guard against negative side effects, such as funding being siphoned from deserving nonprofits that aren't well positioned to participate in PFS transactions, if they are attuned to these potential pitfalls from the outset.

8. **Shouldn't government be providing or directly funding these early intervention or preventative services?**

Perhaps, if resources were unlimited. Since the recession, there has been an increasing demand for social services. Many governments do not have enough resources to meet it. Current social service priorities—such as mounting pension, Medicare, Medicaid, and remediation services—continue to expand and put pressure on discretionary budgets that might otherwise be used to consistently and reliably fund preventative and early-intervention services. Further, there is often a challenge in funding preventative services that impact multiple public agencies or systems. For example, public investment in housing may generate cost savings for publicly-funded health care systems, but in tight fiscal environments, disagreement can arise as to which entity should bear the upfront cost of providing the upfront investment. PFS/SIB can offer a mechanism for funding such programs that one single government agency may not be willing to fund alone, upfront.

Nevertheless, it is true that preventing social issues can cost less than remediating these issues down the line, which points to the strong rationale for government investment on the back-end of PFS deals. For instance, a SIB project aiming to reduce recidivism may scale provision of a high-quality program that provides social services for individuals coming out of prison at a cost of $7,000 per individual served; by way of contrast, incarcerating that same person for a year could cost upwards of $30,000 in state and federal dollars, on average.

In some instances, the interest in and development of a PFS/SIB transaction will result in governments paying for a high-impact preventative program directly rather than engaging private investors to bear the risk of achieving outcomes. In others, PFS/SIB may enable the provision of innovative and promising projects that may have lower levels of empirical evidence of effectiveness. In this scenario, private investors pay to test and demonstrate the efficacy of preventative interventions, which can later be adopted by government.

9. **Should philanthropic foundations, working with governments, fund social services directly?**

Philanthropic capital plays a critical role in the funding of social services. However, the entirety of available philanthropic capital does not come close to meeting the costs of funding needed services. Foundations do have a special role they can play in preparing the social service field for adaptation to more outcomes-oriented funding arrangements including Pay for Success. The future of Pay for Success will likely require support from foundations in a number of areas. These roles may include:

- investing in the readiness of nonprofits;
- funding the up-front costs of delivering services;

- assuming risk in Pay for Success agreements in order to attract private capital; and
- supporting knowledge-sharing and field-building to encourage healthy adoption of financing innovations.

10. Why are commercial banks and private investors interested in PFS/SIB?

One of the attractions of well-constructed PFS/SIB agreements is their potential to enable and encourage the entry of new private capital investors to expand the provision of high-impact preventative and early intervention programs. The entry of private capital is not meant to subvert or replace the role of philanthropy or government, but rather, to complement and expand the current resources for addressing social problems.

Impact investing, which provides both social and financial return, is of growing interest to many private investors. Additionally, the transfer of wealth to a younger and more socially-oriented generation is a driver in the growing number of individual impact investors. PFS/SIB projects are one type of impact investment being explored by private banks, donor-advised funds of community foundations, foundations seeking social investment, and other mission-oriented investors. These projects also present the opportunity for financial institutions to steward responsible investment and meet broader impact goals, including those of the Community Reinvestment Act.

11. Is PFS/SIB privatization?

Because PFS/SIB can include private dollars providing upfront investment to deliver public services, some have argued that PFS/SIB has elements of privatization in terms of the financing mechanism. However, it is critical to note that in PFS/SIB arrangements, governments (as back-end payors) retain a role in procuring service providers qualified to deliver outcomes, and for paying for those outcomes.

Nonetheless, given the involvement of private capital, one of the stated concerns with PFS/SIB models is the potential for external private players to exert inappropriate influence over governmental policies and the delivery of social services. Ultimately, the extent to which concerns are warranted comes down to the integrity with which individual PFS/SIB projects are developed and contracts are constructed.

It is also worth noting that the “profit” that investors *may* realize, if the contractually agreed upon outcomes of a PFS project are achieved, includes recovery of the cost of lending against risky but socially important project outcomes. Interest payments are not new in government finance, and in fact are central to all government borrowing and contracting. However, unlike traditional government finance (municipal bonds, for example), taxpayer dollars are *only* used to repay investors when a project is successful in delivering outcomes. If a PFS project does not achieve its intended outcomes, government does not spend any money. If a project is successful, however, investors are repaid principal and modest rates of return relative to the risk of financing social outcomes. The return a government pays is, in essence, a premium for not bearing the upfront full cost—and risk—of achieving positive social outcomes. The alternative to paying this interest “premium” is risking all of government’s funding upfront on projects that may or may not work.

12. Why are transaction costs so high for PFS/SIBs?

We are currently in the early stages of the development of the US PFS marketplace. At this juncture, each project is essentially unique. Time and effort is required of multiple stakeholders developing new, innovative ways to collaborate and resource these projects. As is the case with many emerging models, some of these costs may be lowered as the broader market matures and there are standard replicable PFS/SIB structures. Costs will also likely remain high until "systems capacity" (data analysis, collaboration between intergovernmental agencies, etc.) is more developed within government, intermediaries, and service providers.

It is also worth considering that transaction costs that result in the scaling of successful interventions may well lead to savings that continue to accrue beyond the original project term (e.g., a five year project to reduce recidivism results in savings beyond that project period for each individual who stays out of prison thereafter) and may also support greater government efficiencies beyond a particular project (e.g., access to administrative data utilized to calculate local costs of homelessness and programs intended to reduce homelessness).

13. Can PFS/SIB contracts be used if a project doesn't yield significant cost savings?

To date, SIBs in the US have been structured to repay upfront investment with captured savings to the back-end payor. However, there are PFS projects in development in which back-end payors are motivated by the potential creation of societal benefit that goes beyond what can be measured and/or monetized in the typical five- to seven-year PFS project investment term. In such projects, back-end payors may be willing to repay upfront investors who finance the scaling of programs that have perceived or anticipated values beyond those that can be monetized or captured at the back-end payor level or within the PFS contract term. For instance, there are governments currently using PFS to scale the provision of pre-kindergarten education. While scaled pre-K can lead to some results that can be measured in a typical PFS contract term (such as improved average daily attendance rates and better third-grade test scores), there are additional societal benefits possible further in the future, such as high school graduation and workforce readiness and participation.

14. Should PFS/SIBs be used to demonstrate the effectiveness of promising and innovative programs, not just proven interventions?

Opinions differ on this issue. Some support using Social Impact Bonds specifically only in a manner that leverages financing from private capital for scaling proven interventions where there is a lack of sufficient government/ philanthropic funds to do so. Another perspective is that PFS arrangements more broadly should be used to have private capital take on the risk of testing innovative approaches and that proven interventions should be funded through traditional government and philanthropic sources. Depending on the goals and objectives of the stakeholders involved, PFS/SIB structures can be used either to scale proven preventative services or to advance innovative approaches to addressing complex social issues.

15. What is the necessary level of evaluation in a PFS project?

There is not universal consensus on the level of evaluation to use in PFS projects. In early conversations around SIBs, the "gold standard" of evaluation—a Randomized Control Trial (RCT) — was considered critical. Now, various approaches are being explored to assess the validity of projects' outcomes. There are a variety of methodologies capable of collecting strong evidence of a program's effectiveness such as longitudinal data, random discontinuity designs, and quasi-experimental designs. Here are some considerations for selecting an evaluation method:

- Purpose of evaluation: some types of evaluation are better suited to improving a program internally, whereas others facilitate scaling a program or expanding to new locations.

- Ethical considerations: RCTs exclude a portion of the population from services to form a control group, which may conflict with an organization's mission to serve all constituents.
- Budget constraints: some forms of evaluation are more expensive than others; as long as the rigor of the evaluation methodology is reasonably aligned with the risks, a lower cost evaluation methodology may be applicable and appropriate.

16. How do projects avoid "skimming" or other perverse incentives when payments are based on outcomes?

In situations where success is predicated on achieving positive outcomes, there is concern over the potential for "skimming" – a biased selection of program participants believed to be the most likely to achieve positive outcomes. Addressing skimming should be prioritized when developing PFS/SIB contracts. All project stakeholders, including independent evaluators and service providers, should have an equal voice in how program participants are selected. Contracts can incentivize the treatment of all sub-sections of the target population. For example, a project targeting childhood obesity could incentivize progress across the full spectrum of the population: those who are borderline, obese, severely obese, morbidly obese, and super obese. Having all stakeholders have a voice provides a balancing mechanism, as each party will have varying preferences and biases, contributing to built-in checks and balances during design.

17. What happens after a PFS/SIB concludes?

Agreements should be designed from the start with the end result of enabling measurable progress toward social goals in mind. It is difficult to know what will happen to a specific program scaled through a PFS/SIB transaction. One possibility is that the government continues to directly fund the scaled program, and scales it further. Alternately, another PFS/SIB transaction may follow the first as an alternate means of enabling further project scaling, thereby allowing a successful intervention to reach additional people or geographies. Private investors could choose to reinvest their PFS/SIB investment proceeds into subsequent transactions, thereby "recycling" private capital to further scale service delivery. In any case, as the first Pay for Success projects close, the outcomes and experiences of those projects will inform the fast-evolving social finance field.

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