

A primer on social impact bonds

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Abstract

A social impact bond is an innovative type of multi-stakeholder contract that aims to redistribute both risk and benefits from investment in social programs, in order to generate greater social impact. As of 2014, social impact bonds (SIB) have been developed in several countries, with at least 25 projects commissioned around the world. This paper provides a global perspective of SIB's development, and a first glance at their potential for Latin America.

I. An overview of SIB

A. What are Social Impact Bonds?

Social Impact Bonds (SIB) are a new approach for addressing social issues that relies on result-based or pay-for-success financing. According to the Development Impact Bonds Working Group,¹ “SIB transform social problems into investible opportunities. Private investors provide working capital -and assume risk- for development programs which are then carried out by specialized service providers.” SIB are multi stakeholder contracts that offer governments the opportunity to pass on the risk of their investments on social policies to external investors such as Development Agencies or Foundations. Governments will remunerate the investors depending on whether the contractually established social outcomes are reached.² Despite what its name might suggest, there is a difference between a SIB and a bond and SIB are not debt instruments.³ The difference lies in the fact that a SIB is not a traditional debt emission. In a bond and in a SIB, payment depends on the determined interest rate and term, but in a SIB it also depends on whether the established objectives are effectively reached at the end of the term. Rather than a bond, it is a partnership.

SIB are adequate for complex issues that require a preventive multifaceted solution. If that preventive approach is more economical than a remedial one, savings can be generated thus granting an economical legitimacy to the social impact bond. The multifaceted solution is produced by complementary service providers, who work on a customized upstream intervention by dealing directly with the sources of the problem. For a SIB to be appealing both to investors and outcome funders, it should deal with an issue that is painful for society and, as a consequence, whose resolution will have a great impact on it, such as recidivism or homelessness.

¹ Center for Global Development and Social Finance (2013) Investing in Social Outcomes: Development Impact Bonds, The Report of the Development Impact Bond Working Group.

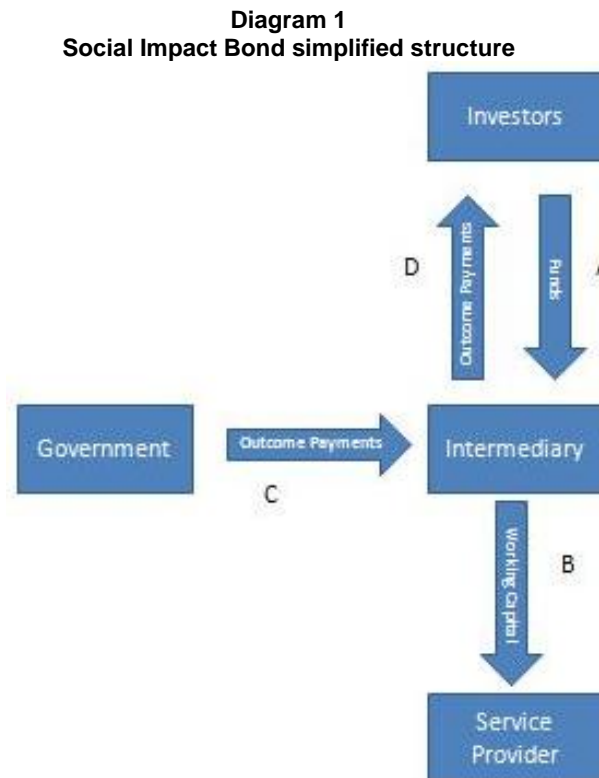
² Ana Demel (2013), Second Thoughts on Social Impact Bonds, 9 N.Y.U. J. L. & BUS.

³ Lenny Mendoza, Laura Callanan and Jonathan Law (May 2012), From Potential to Action: Bringing SIB to the US, McKinsey&Company.

1. The Structure of SIB

The commissioner of a Social Impact Bond is the party of the contract that will pay for outcomes, and as a consequence he has a great influence over the target issue and population chosen for the project. It is often a governmental institution that can partner with an intermediary⁴ such as Social Finance in the UK. To begin the process, the commissioner has to decide on an issue and a target population for the Social Impact Bond to tackle. SIB are not suitable for every social issue, which is why the next step is to conduct a feasibility study in order to estimate the cost efficiency of the SIB and compare it to other financing options. The feasibility study should allow the commissioner to decide whether or not to continue the process for the implementation of the SIB. An argument in favor of the SIB is the generation of cashable savings, which will be redistributed as interest to the investors, thus partially or totally covering the cost of the program. If the SIB seems viable, and there are investors interested in financing the project, all parties will have to agree on measurable expected outcomes, on a cohort and on a control group, and on the financial outcomes for each stakeholder⁵. At this step of the process, a key element to be discussed is timing, along with the methodology that will be used to measure and evaluate the outcomes.

When the stakeholders have agreed on all these aspects, they can write down the contract and manage the legal issues eventually attached to it. The implementation of the SIB has the following steps:



Source: Harvard Kennedy School (June 2013), Social Impact Bonds, a Guide for States and Local Governments

⁴ See Stakeholders on page 9.

⁵ Ann Griffiths and Christian Meinicke (April 2014), *Introduction to Social Impact Bonds and Early Intervention*, Early Intervention Foundation.

1. Investors invest (Y) in the project, as represented by **A** on figure 1. They contractually agree with all the other stakeholders on an outcome (X), to be achieved in (t) time. The performance based payments will depend on whether the outcome X is achieved.
2. The intermediary collects the investments and transmits them to the service providers as working capital, as shown by **B** on figure 1.
3. The service providers produce the social outcome, which could eventually lead to budget savings.
4. The SIB's performance is managed during its implementation: data collection allows effective decision making.
5. At time t, outcomes are evaluated by an independent organism: the evaluator.

If outcomes = X, the outcome funder (usually the government) pays the intermediary Y+ Return. If outcomes < X, the outcome funder doesn't remunerate the intermediary or partially remunerates him, depending on the contract. On figure 1, **C**.

1. The intermediary makes the outcome payments to the investors, represented by **D** on figure 1.

After the end of the program, the commissioner must ensure the service recipients are not suddenly left to themselves without care. If the program proves to be successful, the government can either decide to continue financing it through a SIB, thus maintaining the focus on outcomes, or to switch to a more traditional form of financing.

2. The stakeholders

a) Investors

The investors provide the working capital for the service providers, and they bear the risk of project failure. If the expected outcomes are not reached by the end of the period established, the investors may not recover their principal, or may partially recover it, depending on the contract. Up to now the investors in the existing SIBs have been "impact investors".⁶ "Impact investors" is the name given to investors that are supposed to have philanthropic concerns, and are not only focused on returns but rather on the social impact their investments have. These investors can be moved by a variety of motivations. For instance for foundations, SIB are a way to have returns on investments, and to recycle their capital by reinvesting it on another social project, once they recover it. Some investors are interested in investing on a particular area such as education, like for instance the Bill and Melinda Gates foundation in the US. SIB could be appealing to corporations wishing to have a positive impact on a particular community geographically delimited (extracting companies for instance). Another motivation for foundations that are already investing on an intervention or a service provider is to invest in a SIB to scale it up.

Investors' risk aversion and profit orientation vary depending on these motivations. Financing a SIB with a pool of investors allows mixing impact investors with higher appetite for risk and high returns, with investors that have concessionary return expectations, and are willing to trade lower returns for a higher social performance. For instance, Bloomberg Philanthropies provided a 7.2 million dollar guarantee in the NYC Social Impact Bond with no expected returns whatsoever. Goldman Sachs provided a loan with outcome dependent returns. Bloomberg Philanthropies' guarantee was meant to repay part of Goldman Sachs' loan, if no outcome payments were made because of insufficient outcomes.

⁶ Nick O'Donohoe, Christina Leijonhufvud, Yasemin Saltuk, Antony Bugg-Levine and Margot Brandenburg (November 2010), *Impact Investments An emerging asset class*, JP Morgan and the Rockefeller Foundation

b) Outcome funders

The outcome funder provides the funds to remunerate the investors in case the outcomes are effectively generated, paying the principal as well as the interests established by the contract. In most cases the outcome funder in a SIB is the government (central or local). Payments are made with the intermediary's intervention as discussed below.

c) The intermediary

The key role of the intermediary is to bring together all the project's stakeholders, to be at the heart of the set of relationships, in order to build the best possible contract that fits the needs and capabilities of every part. Intermediaries can have different degrees of implication in the project: they may supervise the project during its implementation and even suggest modifications. The intermediary is in charge of receiving the funds from the investors and passing them on to the service providers, as well as receiving the payment from the outcome funders and making outcome payments to the investors.

d) The service provider

The service provider is the party of the contract that has to work with the service recipients and deliver the social outcomes outlined in the SIB contract. It receives the funds to be used as working capital from the intermediary at the beginning of the program. Nevertheless, this party can actively raise funds for the project, along with the intermediary, or even invest its own capital in the project as a proof of commitment. Service providers are generally NGOs or nonprofit organizations, and the participation of profit oriented service providers could be complicated on an ethical and economic level. Several complementary service providers often collaborate in SIB; they allow a single program to bring together multiple services to address all the aspects of a complex issue.

e) The evaluator

The evaluator is an independent organism that determines whether the previously established outcomes were reached by the end of the time period. The outcome payments will result of its judgment. The methodology by which outcomes will be measured is to be determined in the contract, and it is one of the biggest challenges of SIB.

“Development Impact Bonds” Development Impact Bonds are financing mechanisms similar to SIB, where the outcome payer is a donor country (through an official agency) or a donor organism instead of the country's own government. There can be hybrids, half SIB and half DIB, if the outcome funders are a government and an international donor (such as a development agency or a foundation) combined. The first DIB is currently being implemented in Rajasthan, in India.

The current wave of interest for SIB can be explained by the potential advantages they could offer to the different stakeholders, and more generally, to society. For instance, governments have limited financing capabilities and often face budgetary restrictions. Social Impact Bonds provide them with a new financing mechanism in which private investors manage risks, and governments don't have to mobilize capital right away so they can plan their budget years in advance to be able to repay investors. This encourages innovation by reducing the risk for governments, and by allowing more flexibility in the interventions. As payments are based on outcomes instead of outputs, service providers can manage their interventions and adapt them to the needs of the beneficiaries during the implementation of the SIB, which is almost impossible to do with traditional contracting ways such as RFT (request for tender). In traditional private-public contracts for social services, service providers are expected to generate outputs by following a method determined by the contract, which constraints the service providers' ability to adapt to the needs of the recipients. In SIB the programs do not have a rigid structure, but a flexible one shaped by the empirical knowledge acquired during the implementation.

As SIB bring private stakeholders to cooperate with governments in order to finance projects of public interest, they increase the pool of money available for social programs. As it was mentioned before, these investors are mostly impact investors. Those socially oriented investors are essential for Social Impact Bonds at the early stage of development in which they are now, because returns are not competitive enough and investors have to dedicate a significant amount of time and effort to these projects. Profit oriented investors are unlikely to be interested in SIB, as long as they remain a quite new and unknown financing mechanism.

The logic being SIB is that they are based on the stakeholders' complementary comparative advantages and creates incentives for each of them.⁷ Governments select the social issues to be tackled according to the population's needs and ultimately finance the social projects, investors manage risk and provide the working capital, and service providers deal with the beneficiaries. Financing the social services with non public investors has several advantages, among which is investors' incentive to select the most effective programs, creating a market-like selection and hence improving the quality of social interventions. It is also in investors' interest to create feedback loops, collect data, and settle performance management systems⁸ which has positive effects on the entire program.

The incentives SIB create encourage stakeholders to make the necessary efforts to generate the expected outcomes by making use of their comparative advantage, which will make public spending more efficient. In order to recover their investment and receive returns, investors may offer their expertise to bring rigor and better resource management to SIB, which would benefit all stakeholders. Because of the market-like selection, service providers are encouraged to offer good value to outcome funders, if they want to be chosen for the project. They also face a reputational risk,⁹ because SIB are broadly covered by the media, and a failure of a social program would stain a service provider's image. SIB have several positive effects on governments: political cycles usually rule public initiatives, privileging short term expenses. SIB are long term public policies whose social impact takes years to be measurable; as a consequence, they increase governments' long run vision. Another positive effect SIB have on governments comes from interacting with investors and service providers: it develops government capabilities such as data collection.¹⁰ When several service providers with different approaches to the same issue collaborate in the same SIB,¹¹ they generate complementary data on the target population. Furthermore, SIB's transparency requirements increase governmental accountability: voters can know exactly what impact the government's budget is having. These examples of positive externalities make SIB's added value, which can compensate for their high economic cost.

B. SIB around the world

SIB have multiplied over the last 4 years. The first one was implemented in the UK in 2010, and was then followed by 14 others in 2012 in the UK and the US. As of 2014, 25 SIB have been commissioned around the world, raising more than US\$ 100 million (Figure 2).

So far, SIB have been used to scale up programs that had proven to be effective on a smaller scale, because they allow governments to test innovative solutions on wider populations without having to deal with the risk of failure. In general, these innovative solutions have often been preventive meaning that they could lead to public savings (long after the programs are implemented) if they manage to reduce the need for remedial programs. For instance, a program focused on reducing recidivism could eventually reduce incarceration spending, hospital fees and other expenses in the future. The logic behind the SIB model is that the funds to pay interest for investors should ideally come from such public savings.¹² Nevertheless, as it will be seen further on, those expected savings are hardly measurable, and in emerging countries they are unlikely to compensate government's expenses in interests.

⁷ World Economic Forum (April 2014), *Creating New Models Innovative PPP for Inclusive Development in Latin America*, WEF.

⁸ Center for Global Development and Social Finance (2013), *Op. cit.*

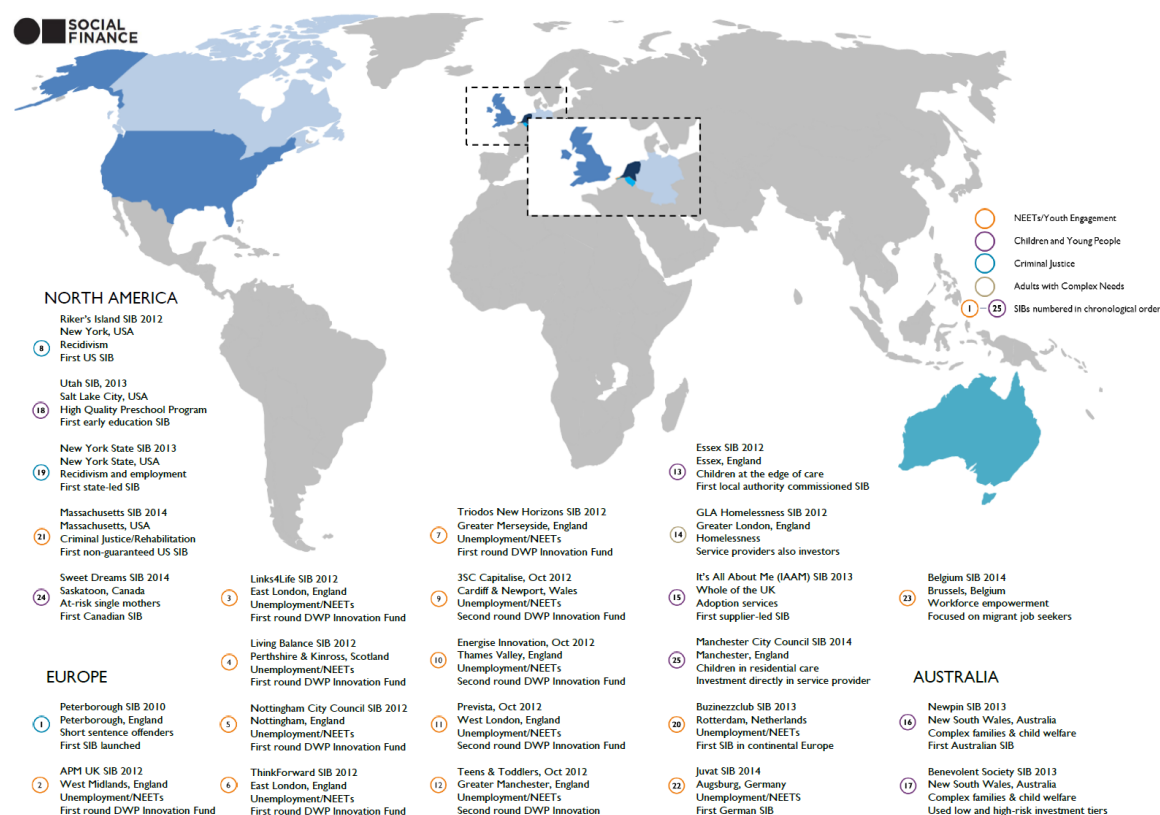
⁹ MaRS Center for Impact Investing (November 2013), *SIB Technical Guide for Service Providers*, P.8-9

¹⁰ Emma Tomkinson (November 2012), *An Australian snapshot: Social Impact Bonds*, the Center for Social Impact

¹¹ Lisa Barclay, Tony Simons (January 2013), *Guide to Social Impact Bond Development*, Social Finance

¹² Jeffrey Liebman and Alina Sellman (June 2013), *Social Impact Bonds A Guide for State and Local Governments*, *Op. Cit.*

Diagram 2
SIB around the world



Source: Social Finance (August 2014), *The Global Social Impact Bond Market*.

Because SIB have been recently implemented, only a couple of them have been working long enough to allow some preliminary conclusions.

1. Projects overview

The first SIB followed the structure previously detailed in this document. It was implemented in the United Kingdom in 2010, in Peterborough. The program tackled recidivism and was meant to be 7 years long; it managed to raise 7.6 million dollars of investment from 17 different trusts and foundations. The government was the outcome funder along with a foundation, the Big Lottery Fund. The investors could expect a maximum return of 13%, while their entire principal was at risk.¹³ Service providers, innovative social enterprises, were contracted under a program called The One Service.¹⁴ Bringing together complementary service providers in single organization is a way to coordinate the efforts necessary to address all the different needs of the participants. Indeed, the added value of The One Service is that it collects data from all providers, and centralizes it, for a better follow up of the participants. If during the implementation of the program, it is found that a service doesn't fit the needs of the beneficiaries, the One Service is in charge of making the necessary changes, which allowed even more flexibility. This SIB served as a pilot to foster the creation of the other projects that followed, in the UK and abroad.

¹³ Alex Nicholls, Emma Tomkinson (2013), *The Peterborough Pilot Social Impact Bond*, Saïd Business School University of Oxford.

¹⁴ The One Service includes several service providers that work together in order to achieve the outcomes expected from the SIB: Social Finance (August 7th 2014), *Press Release*, Social Finance Ltd.

The first phase of this SIB did not generate enough outcomes to trigger payments to investors, which required a drop of 10% in reconvictions among the first cohort. For the first cohort that benefited from the program, the reduction of recidivism was of 8.39%.¹⁵ To trigger final payments, the program will have to generate at least a 7.5% reduction of recidivism among all cohorts together. Despite its likely success, this first implemented SIB uncovers several challenges, the first one being measurability.¹⁶ Isolating the effect of the SIB from other external factors, and not only isolating it, but quantifying it to match the outcomes criteria established previously is a key challenge for every result-based program that focuses on outcomes rather than outputs. Measuring outcomes in SIB is a lengthy process particularly in small scale programs with small samples: data is less reliable and as a consequence it requires a longer period of time to be trustworthy. In the Peterborough SIB, four years will be necessary to make investor payments for that reason.¹⁷ The fact that SIB take place during such long periods of time has several consequences among which is the necessity of a considerable management and monitoring effort that generates high costs.

High transaction costs in comparison with other contracting alternatives, such as traditional private public partnerships,¹⁸ are another burden for SIB stakeholders: SIB are costly in terms of both time and money. The Peterborough SIB could only be launched after 18 months of previous work, and according to Social Finance, the organization had to invest around 2.5 person years of resources and more than 300 hours of pro bono legal advice.¹⁹ The Peterborough SIB also showed it is unlikely that governments can benefit from cashable savings in small scale SIB²⁰ and the savings brought by the programs will not be immediately obtained, or directly identifiable.

After the first experience of the Peterborough SIB, the interest for SIB spread around the world. New York City launched a SIB to reduce youth recidivism in September 2012. Its structure is similar to Peterborough's and it is meant to last until July 2017. The investors in this project are Goldman Sachs, and Bloomberg Philanthropies. Goldman Sachs provides a US\$ 9.6 million loan as a commercial lender, and Bloomberg Philanthropies guarantee that loan with a US\$ 7.2 million grant. Figure 3 below shows the payment terms of the NYC contract.²¹

¹⁵ Darrick Jolliffe and Carol Hedderman (August 2014), *Peterborough Social Impact Bond: Final Report on Cohort 1 Analysis*, QinetiQ and University of Leicester

¹⁶ Fiennes, C. (2013), *What the First Social Impact Bond Won't Tell Us*, Stanford Social Innovation Review

¹⁷ Deborah Burand (2013), *Globalizing Social Finance: How Social Impact Bonds and Social Impact Performance Guarantees Can Scale Development*, 9 N.Y.U. J. L. & BUS. 447

¹⁸ KPMG (January 2014), *Evaluation of the Joint Development Phase of the NSW Social Benefit Bonds Trial*, NSW Treasury.

In traditional PPP contracts, transaction costs weight less because of the magnitude of the contracts. SIB are relatively small contracts of greater complexity, because of the stakeholders they involve and the private investors they engage, and are thus more affected by these costs.

¹⁹ Emma Disley, Jennifer Rubin, Emily Scraggs, Nina Burrowes, Deirdre Culley (May 2011), *Lessons learned from the planning and early implementation of the Social Impact Bond at HMP Peterborough*, UK Ministry of Justice

²⁰ Emma Disley, Jennifer Rubin, Emily Scraggs, Nina Burrowes, Deirdre Culley (May 2011), *Op Cit 20*.

²¹ Timothy Rudd and other authors (December 2013), *Financing Promising Evidence-Based Programs, Early Lessons from the New York City Social Impact Bond*, MDRC.

Table 1
NYC SIB – Summary of payment terms by impact

Recidivism reduction rate	Department of correction success payment (\$)	Net projected taxpayer saving
≥ 20.0%	11 712 000	20 500 000
≥ 16.0%	10 944 000	11 700 000
≥ 13.0%	10 368 000	7 200 000
≥ 12.5%	10 272 000	6 400 000
≥ 12.5%	10 176 000	5 600 000
≥ 11.0%	10 080 000	1 700 000
≥ 10.0%	9 600 000	< 1 000 000
≥ 8.5 %	4 800 000	< 1 000 000

Source: MDRC Timothy Rudd and others (December 2013), Op. Cit.

Goldman Sachs can lose up to 2.4 million dollars in this project, if the program fails to create the minimum outcomes required for a success payment to take place (8.5% recidivism reduction rate).

Although no figures have been communicated yet, the report²² published by the MDRC underlines two early lessons learnt from the SIB's implementation: the importance of reassuring private investors through mitigating risks, and as for the Peterborough SIB, the need to reduce SIB's transaction costs for a future extension of the model.

These two implemented SIB reflect three challenges that are likely to affect every SIB. First, the issue of measurability and quantification of a qualitative outcome, second, the challenge of making these contracts attractive to investors, despite the existing risks and finally the challenge posed by the high transaction costs involved as there are no standardized SIB contracts and these have to be tailor made every time. For every SIB, in depth studies have to be conducted to analyze the targeted population, the service provider, the expected outcomes etc.

The current trend of associating the private sector with development and social issues is impacting the worldwide expansion of SIB. This expansion isn't limited to developed countries: emerging countries (Colombia, India) are designing social impact bonds as well. Latin America is no exception to this trend, and the following section examines SIB's stage of development in the region and the challenges for further expanding.

²² Timothy Rudd and other authors (December 2013), Op. cit.

II. SIB in Latin America: experience and challenges

Social Impact Bonds aren't as developed in Latin America as they are in the United Kingdom or the United States. However, there have been some initiatives towards the implementation of SIB in the region. The first one took place in the department of Antioquia, in Colombia in 2012. Antioquia has very low schooling rates, particularly among rural populations and, in order to increase school retention a social impact bond is being designed by Instiglio, an intermediary, along with the Government of Antioquia and the *Dividendo por Colombia* NGO. This NGO would be the service provider; the government of the department would be the outcome payer, and Instiglio the intermediary. The investors haven't been determined yet, and the project is on hold due to political-cycle issues.²³ Although the project is far from being implemented, it is a first example of SIB negotiations in Latin America.

A more recent initiative regarding SIB in LAC has been undertaken by the Interamerican Development Bank's (IADB) Multilateral Investment Fund (MIF). In March 2014, the MIF announced it would launch a US\$ 5.3 million program²⁴ to develop SIB in Latin America. A fraction of such investment (US\$ 2.3 million) would be channeled towards supporting local stakeholders - such as service providers and governments- with technical advice and know-how during the design and the implementation phases of the SIB. The remaining fraction of the investment (US\$ 3 million) would be channeled towards directly financing at least two or three pilot SIB projects in countries of the region. Although no countries have yet been selected, MIF has established several criteria to determine where the pilot projects will be implemented. Selected countries should have experience and a coherent regulatory framework in the field of public-private partnerships (PPPs), well developed financial markets, capable service providers and available historic data on social sector issues. According to the IADB, the countries most likely to be chosen for the program are Brazil, Chile, Colombia, Mexico and Uruguay.

The interest of Latin-American stakeholders towards SIB is motivated not only by the potential advantages in terms of increased public spending efficiency as already discussed, but also by other

²³ Instiglio's Website, <http://www.instiglio.org/en/education-antioquia/>

²⁴ Zachary LEVEY (Mars 2014), *FAQ – Social Impact Bonds in Latin America and New MIF Pilot Program*, Fomin.org

potential benefits that the SIB model could pose for the region. Although in the past decades Latin American –and particularly South American governments– have considerably broadened their provision of public services, there remains the challenge of improving quality of such services and, very importantly, of reducing the inequality of access that characterizes some social services.²⁵ In this sense, well targeted SIB could provide a means of improving access to services by certain population groups —among them informal workers for example— that currently remain outside formal social protection schemes.

Despite the potential advantages of adopting the SIB model in Latin America, the question arises of whether such model is indeed transposable to LAC. SIB currently exist almost exclusively in developed countries, which are very different from Latin American countries in social, economic, political and institutional aspects and this implies that there will exist specific challenges regarding the implementation of SIBs in a developing region like LAC. The first challenge is cost related: SIB are costly and it remains to be seen if LAC governments are willing and able to afford such costs in exchange for SIB advantages. A second challenge is the issue of the different institutional contexts characterizing countries where SIB have already been implemented with respect to LAC countries' institutional contexts. Finally, a third challenge is the issue of financing SIB implementation in LAC countries and whether this will be a feasible task. We discuss all these issues below.

A. SIB's High Cost

Information and data availability are crucial in a SIB and this is very costly

Every step of the social service has to be planned in advance, to estimate the expected outcomes and evaluate the potential social impact of the project. Furthermore, in order to measure and reduce the risks of the project, the stakeholders of the SIB need to have detailed information on the issue they plan to tackle: updated national databases on social sector issues are needed. Data is also needed to evaluate the progress accomplished. For instance, if the SIB deals with recidivism, the service providers need to have access to the criminal records of the participants. In the case of recidivism, accurate recidivism statistics need to be available for the independent evaluator. Otherwise, the evaluator would need to individually monitor the participants after the end of the intervention to measure its outcomes, which would be costly. More generally, the need to conduct independent studies because of the lack of data implies heavy costs for the SIB,²⁶ added to the data analysis costs. The issue of data availability can have direct repercussions on the risk of the projects. If the programs haven't been previously evaluated, there is no evidence of their effectiveness, and the risk is higher for the investors who will therefore be expecting higher returns.

The potential public savings generated by SIB elsewhere are unlikely to occur in LAC.

In developed countries, welfare state governments allocate considerable budgets to public policies, and these budgets are widely used to finance expensive remedial services. Developing countries of LAC haven't developed such extensive public services yet: the services SIB could provide wouldn't make other remedial services unnecessary the way they do in developed countries. As a consequence, savings are unlikely to be generated in the region. In this sense, the potential advantages of SIB for Latin America are not budget related,²⁷ at least on the medium-short term.

B. Institutional context and political issues

For the SIB model to be transferable to Latin America, it should fit in the countries' institutional and regulatory context. SIB are a complex new type of contract, with multiple and diverse stakeholders, deferred results based payments, and a social goal. Although the upfront investment of adapting the SIB

²⁵ Simone Cecchini, Rodrigo Martínez (2012), Inclusive Social Protection in Latin America: A Comprehensive, Rights-based Approach, ECLAC

²⁶ Michael Belinsky & Sebastian Chaskel (November 2012), Designing a SIB in the Tropics, Stanford Social Innovation Review blog.

²⁷ Michael Belinsky & Sebastian Chaskel (November 2012), Op. Cit.

contracts to Latin American legislations will be costly, the implementation of the first SIB will facilitate the legal implementation of the ones to come, the way it happened with Public-Private Partnerships (PPPs). One aspect to take into account is whether local governments have the legal authority to sign such contracts, or only national governments do, and how the different levels of government will have to interact during the SIB. Cooperation between municipal, regional and national institutions is often necessary in SIB. For instance, a municipal authority, such as a mayor, can prevent a project from happening even if the national authorities agreed on it: poorly integrated government structures can hinder a SIB's development. A way to determine which governments will be better prepared to deal with SIB is to select governments with experience in PPPs¹³. Indeed, Public-Private Partnerships require similar contract negotiation and implementation skills.

There are also political issues that could pose challenges for the implementation of SIB in LAC countries. In the first place, a portion of public opinion might regard SIB as equivalent to the privatization of government services and therefore projects could face important resistance.²⁸ Good communication programs are therefore key for governments seeking to implement SIB in the sense of explaining clearly that SIB fund new programs that wouldn't exist otherwise and that SIB are not supposed to replace existing public services.²⁹

Secondly, political-cycle issues might complicate the implementation of SIB if a government cannot guarantee the continuation of a certain project beyond its own term in office. In the case of Antioquia's SIB project, the project couldn't be developed because of the political cycle: the government interested in commissioning the SIB was unable to guarantee payments would be made when the next government replaced it.

A third challenge regarding political issues is the fact that governments might be reluctant to measure and disclose the results on impact of the SIB projects because the latter could come up worse than expected and therefore could harm them politically. Finally, moral hazard issues have to be taken into consideration: governments could be incentivized to interfere with SIB performance to lower their outcome payments, which is particularly an issue for governments with heavy budgetary constraints, which is the case for several LAC countries.

C. Financing the SIB

The impact investment market is expanding globally, and even though it is still at an early stage, it is expanding in Latin America too. Potentially, there should be a demand for SIB from the region's impact investors.³⁰ Nevertheless, financing SIB in Latin America will present a series of challenges. To begin with, the idea of philanthropy in Latin America draws heavily upon charity and donations, not on investments that produce returns. Introducing result-based financing in the philanthropic sector implies a change of mentality. It requires foundations to switch from grants to investments and as they do not usually require measurable outcomes from service providers they might be reluctant to do so.

For other investors, the main problem of SIB will be their very limited liquidity that could become a barrier to entry. Social Impact Bonds give stakeholders few to no options to exit the contract: for commercial investors, this means they do not hold assets they could exchange on a secondary market. An innovative initiative³¹ to allow high net worth individuals to invest in a SIB with emergency early exit opportunities was developed by Allia, a UK based Social Profit Society along with a charity.³² Nevertheless, the bond could not be issued due to the lack of subscriptions, and even if it had it wouldn't

²⁸ The Canadian National Union of Public and General Employees (February 2014), *Privatization by stealth, the truth about SIB*, PDF at nupge.ca.

²⁹ Mark Hlady (November 16, 2012), *SIB as a catalyst for change (and not a step towards privatization)*, [Socialfinance.ca](http://socialfinance.ca), blog.

³⁰ Fomin Sept 3rd 2014, Taller Introductorio de Bonos de Impacto Social y Experiencias Globales, 9 de Sept 2014, Hotel Ritz Carlton Santiago de Chile

³¹ Abigail Rotheroe, Plum Lomax, Iona Joy (July 2013), *The Future For Children Bond: Identifying the lessons learned from Allia's bond offer to retail investors*, New Philanthropy Capital.

³² Allia (4th February 2013), available at: <http://allia.org.uk/latest-news/2013/02/04/future-for-children-bond/>

necessarily have meant a secondary market could emerge, because every SIB is a different contract and standardization may be impossible. Furthermore, even if the volume of SIB was sufficient, investors could not compare SIB returns and estimate risks based upon their historical performance because the success probability of a SIB depends on the social service provided and they are never the same. Without a track record, it is hard for investors to understand the risk, unless they learn about the specifics of the social service and its outcomes. For investors that are not socially oriented, this would be too costly in terms of time, and they would have to rely on the reputation of the service provider. In brief, it seems it would be hard for commercial investors to place SIB in their risk and profit spectrum. Another issue is that the more profit oriented the investors are, the less they will focus on the social outcome, weakening the value of the SIB. SIB are not meant to generate profit for the investors from social issues, but to act as a more efficient and sustainable financing mechanism.

Other than the high transaction costs inherent to any SIB, some additional factors are particularly dissuasive for investors, impact oriented or not, in Latin America. Implementing SIB in Latin America implies the usual risks of investing in emerging economies: difficulty raising capital, political risks, inflation etc. If the outcome funder is a government, it means the country's sovereign risk is added, and it can be significant in some of the regions' countries. These supplementary risks do not compromise the implementation of SIB, but they have to be taken into account during the planning of the projects.

III. Conclusion

Social Impact Bonds are a financing mechanism that relies on outcome based payments to address complex social issues with an innovative approach. Those outcome based payments foster the quality of and bring rigor to public service provision. Private investors provide the upfront capital in exchange for financial returns conditional on outcomes. They assume the risk of project failure for the government, increasing public spending efficiency with this risk transfer. Investors manage risk to receive returns and following the same logic, each stakeholder is incentivized to bring its comparative advantage to the project. Apart from generating a greater impact, this collaboration generates positive externalities that range from development of government capabilities to better data management for service providers.

Because of these announced benefits, SIB have multiplied around the world since 2010, adding up to 25 commissioned SIB worldwide as of 2014. When it comes to Latin America, several intermediaries have started studying the potential applications SIB could have in countries such as Chile and Colombia. In March 2014, the IADB launched a 5.3 US\$ million fund to develop SIB in Latin America with two aims: creating the right environment for SIB development, and directly financing SIB pilots. At the source of that interest are the benefits SIB can bring to this region specifically: efficient public spending on quality services and government accountability, with more effective targeting of the beneficiaries and the ability to address complex social issues with complementary service providers. Despite the potential advantages the implementation of SIB could generate in LAC, the question arises of whether such a model is indeed transposable to LAC. SIB currently exist almost exclusively in developed countries, which are very different from Latin American countries in social, economic, political and institutional aspects and this implies that there will exist specific challenges regarding the implementation of SIBs in a developing region like LAC.

The first challenge is cost related as information and data availability are crucial in a SIB and this is very costly. Also, the potential public savings generated by SIB elsewhere are unlikely to occur in LAC: in developed countries, welfare state governments allocate considerable budgets to public policies, and these budgets are widely used to finance expensive remedial services. Developing countries of LAC haven't developed such extensive public services yet: the services SIB could provide wouldn't make other remedial services unnecessary the way they do in developed countries. As a consequence, savings are unlikely to be generated in the region. A second challenge is the issue of the different institutional contexts characterizing LAC and countries where SIB have already been implemented. Also, a portion

of public opinion might regard SIB as equivalent to the privatization of government services and therefore projects could face important resistance. Finally, a third challenge is the issue of financing SIB implementation in LAC countries and whether this will be a feasible task at least in the short term as the impact investor market is still at a very early stage in the region and commercial investors.

As a consequence SIB commissioners, whether they are governments or development agencies, need to assess SIB costs in terms of financial resources and working time and weigh up the benefits SIB bring to society with those costs. Commissioners have to consider other financing mechanisms that can be better suited for some social issues, where the complexity of a SIB wouldn't translate in a substantial improvement of the beneficiaries' situation.

The support of multilateral institutions during the initial phases of SIB implementation- as the IADB is currently doing in Latin America- could be decisive in overcoming these challenges. In particular, for instance, they have a part to play in informing public opinion and legitimizing the SIB model in front of the potential mistrust it could generate. Furthermore, they could also support case studies regarding the necessary institutional changes to be undertaken before the implementation of SIB in the countries of the region.

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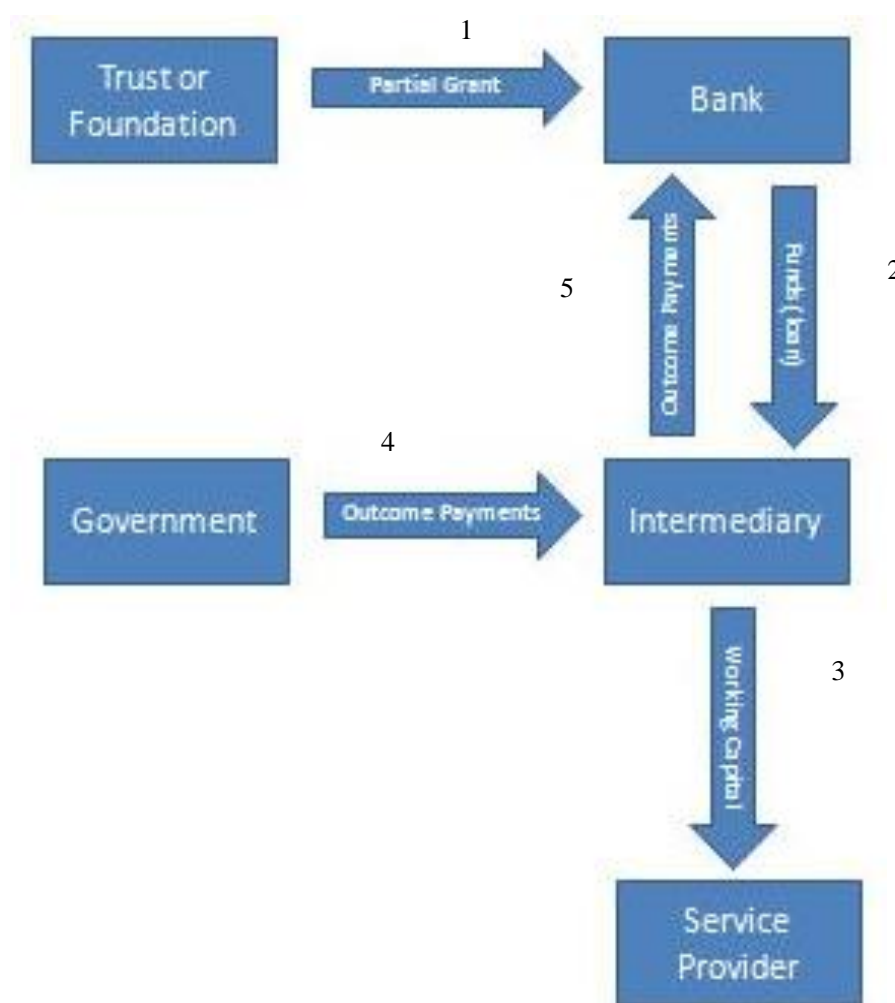
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Annex

Annex

This structure was used in the New York City Social Impact bond.¹⁰

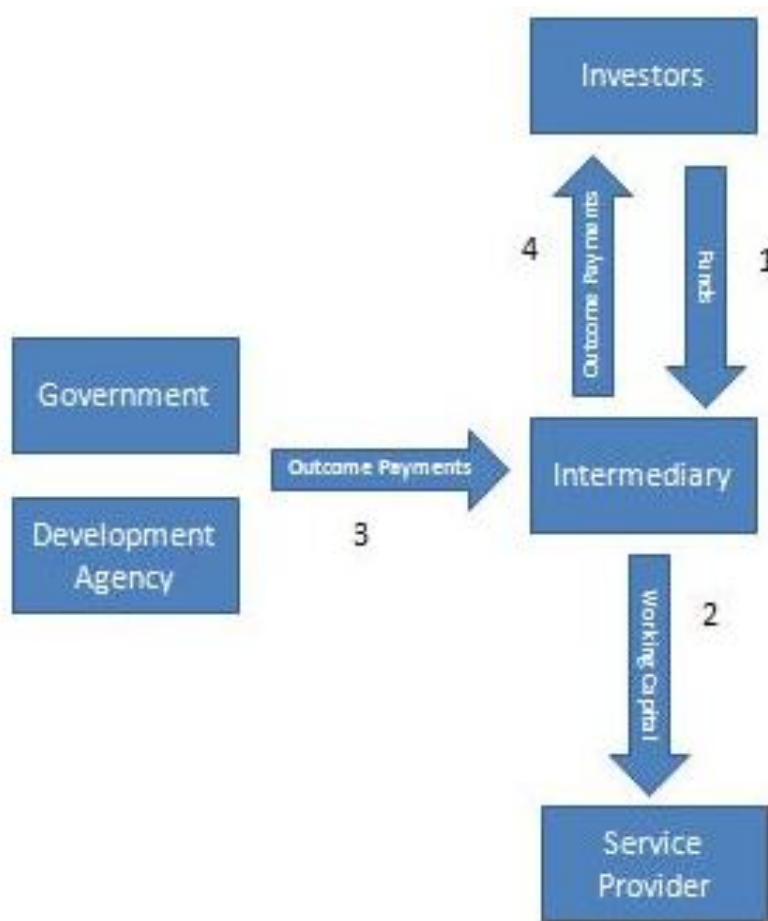


The detail of the different transactions:

1. A Trust or a Foundation (Bloomberg Philanthropies in the NYC SIB) provides a **grant** that partially covers the funds the bank loans to the intermediary.
2. A bank provides (Goldman Sachs in the NYC SIB) the funds necessary for the project. The bank can also loan only a part of the funds. In Latin America, the BID could loan the funds.
3. The intermediary provides funding to the service provider as working capital
4. The Government makes the outcome payments to the intermediary depending on the outcomes.
5. The intermediary repays back the loan depending on the outcome payments. If no outcome payments are made because the targets weren't reached, the Foundation pays the grant to partially cover the bank's losses.

This structure could be a way to fund SIB in Latin America.

This is the structure of Development Impact Bonds, in which Development Agencies are at least one of the outcome funders.³³



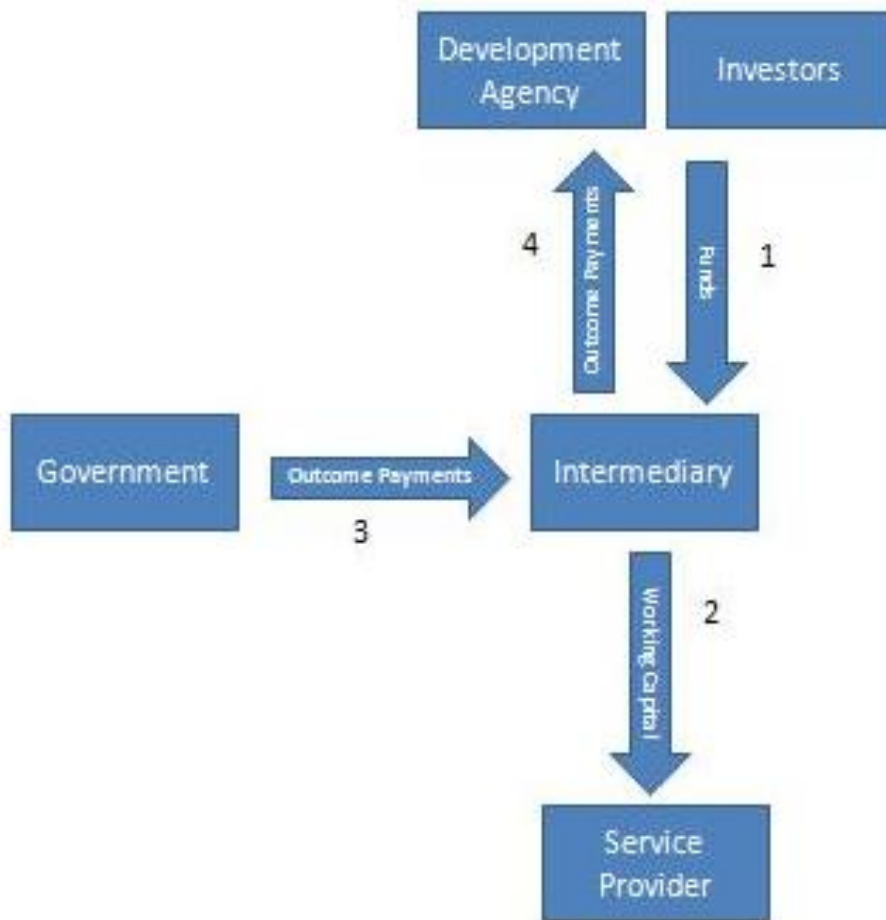
The transactions are as follows:

- 1- The intermediary collects the funds from the investors
- 2- The service provider(s) receive the working capital from the intermediary
- 3- If outcomes are as expected, outcome funders pay the established outcome payments. Development agencies such as CAF or BID could play that role in Latin America.
- 4- The investors receive the outcome payments

If development agencies are at least one of the outcome funders of the SIB, it would reassure investors and encourage governments to participate. For development agencies, it could be a way to make their spending more efficient.

³³ Center for Global Development and Social Finance (2013), *Investing in Social Outcomes: Development Impact Bonds*, the Report of the Development Impact Bond Working Group.

Development Agencies could also be the investors in a SIB15:



The transactions are the same as in the precedent figure, only the development agency is no longer an outcome funder, but an investor.

In Latin America, the network of philanthropic investors is less developed than in the United States or in the United Kingdom: investors for SIB might be hard to find. Development agencies could see SIB as a way to invest in social outcomes, instead of donating, and to potentially receive returns on their investments.