Globalizing Social Finance: How Social Impact Bonds and Social Impact Performance Guarantees can Scale Development

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GLOBALIZING SOCIAL FINANCE: HOW SOCIAL IMPACT BONDS AND SOCIAL IMPACT PERFORMANCE GUARANTEES CAN SCALE DEVELOPMENT

Deborah Burand*

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* Deborah Burand is a Clinical Assistant Professor at the University of Michigan Law School, where she is the founding Director of the International Transactions Clinic, established in 2008. She is deeply grateful to the many people who kindly offered their time and expertise to explore (and debate) the ideas presented in this article, including, in particular, her symposium commentators, Ana Demel and Rebecca Leventhal. She is also grateful for the research support she received from Jessica Finz. Any failures in this analysis, however, belong to Deborah and not to her many generous thought partners.
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"Do the risky things in this world. And then, when you’re looking to scale them, plug into governments. That gives you even more impact."

—Steve Case, former CEO of America Online¹

“We believe this [Social Impact Bond] investment paves the way for a new type of instrument that enables the public sector to leverage upfront funding from the private sector.”

—Lloyd Blankfein, CEO and Chairman, Goldman Sachs²

“I want to use our G8 presidency to push this [social investment] agenda forward. We will work with other G8 nations to grow the social investment market and increase investment, allowing the best social innovations to spread and help tackle our shared social and economic challenges.”

—U.K. Prime Minister David Cameron³


GLOBALIZING SOCIAL FINANCE

I. INTRODUCTION

Governments have long used public/private partnerships to crowd private sector resources—both financial resources and know-how—into building large-scale infrastructure projects. Think toll roads, airports, or power plants. Yet public/private partnerships do not need to be limited to building large, physical infrastructure projects. Public/private partnerships can also be used to tackle development issues like limiting the spread of disease, improving educational opportunities for the world's poor, and preventing the devastating effects wrought by a warming global climate.

4. See generally PPP IN INFRASTRUCTURE RESOURCE CENTER FOR CONTRACTS, LAW AND REGULATION: POTENTIAL BENEFITS OF PUBLIC PRIVATE PARTNERSHIPS [hereinafter PPPIRC], www.worldbank.org/ppp (last visited Apr. 14, 2013) (pointing out the renewed attention public/private partnerships are receiving, particularly as fiscally-constrained governments seek to make large infrastructure investments to promote economic growth).

5. See CTR. FOR GLOBAL DEV. & SOC. FIN., DEVELOPMENT IMPACT BONDS BRIEFING NOTE—MAY 2013, http://international.cgdev.org/sites/default/files/Development%20Impact%20Bonds%20Briefing%20Note%20-%202013.pdf (anticipating the imminent release of a report on six case studies exploring how development impact bonds can be used to improve development outcomes). This broadening of the purposes to which public/private partnerships are applied is starting to manifest itself in national public/private partnerships legislation, too. For example, in 2012 Kenya enacted public/private partnerships legislation that contemplates expressly the use of public/private partnerships for development projects as well as for more traditional, physical infrastructure projects. See The Public Private Partnerships Act, No. 15 (2013), Kenya Gazette Supplement No. 27 §1, http://www.kenyalaw.org/klr/fileadmin/pdfdownloads/Acts/PublicPrivate_Partnerships_ActNo15of2013.pdf ("An Act of Parliament to provide for the participation of the private sector in the financing, construction, development, operation, or maintenance of infrastructure or development projects of the Government through concession or other contractual arrangements . . . ." (emphasis added)). The Kenya Public Private Partnerships Act defines "public private partnership" as:

an arrangement between a contracting authority and a private party under which a private party—

(a) undertakes to perform a public function or provide a service on behalf of the contracting authority;

(b) receives a benefit for performing a public function by way of—

(i) compensation from a public fund;
Creating successful public/private partnerships that develop large-scale solutions to the world's most pressing social problems is a growing preoccupation of many today. Billionaire philanthropists like Steve Case, government leaders like U.K. Prime Minister David Cameron, and investment bankers like Lloyd Blankfein of Goldman Sachs, as well as impact-oriented investors, nongovernmental social service providers, and development assistance organizations are all interested in creating such public/private partnerships. This explains much of the growing interest in a social finance innovation that is being piloted in the United Kingdom and New York City called the social impact bond ("SIB").

While the SIB structure is still in its infancy, there is momentum building to globalize this social finance innovation so that it can help scale development goals around the world.

(ii) charges or fees collected by the private party from users or consumers of a service provided to them; or
(iii) a combination of such compensation and such charges or fees; and
(c) is generally liable for risks arising from the performance of the function in accordance with the terms of the project agreement

Id.

6. See, e.g., supra notes 1-3.

7. Interest in SIBs has been growing in many countries since the launch of the first two SIBs discussed infra Part II. The U.K. has been the global trailblazer in launching SIBs. According to U.K. press accounts, as of the time of the writing of this article, there are ten SIBs underway in the U.K. Patrick Wintour, Social Impact Bond Launched to Help Teenagers in Care and the Homeless, THE GUARDIAN (Nov. 23, 2012).

One recent U.K. SIB is focused on keeping troubled teenagers out of foster care. In late November 2012 the Essex County Council launched a SIB that raised £3.1 million to keep at least 100 troubled teenagers (from a selected group of 380 teenagers) with their families and out of residential or specialized foster care for the next 5 years. The Essex City Council will use the proceeds of this SIB to pay for intensive family therapy for the teenagers. If the Essex SIB is successful in keeping 100 teenagers out of the government-funded care system and living at home with their families for 5 years, it is estimated that the government could enjoy as much as £17 million in savings, and SIB investors could earn an annual return of 8-12%. See Rosemary Bennett, Second Chance: Council Offers Investors a £3m Bet on Youngsters Not Behaving Badly, THE TIMES (Nov. 23, 2012); see also Wintour, supra.

One of the eight investors in the Essex SIB is Big Society Capital, which committed to invest £825,000. See Essex Social Impact Bond, BIG SOCIETY CAPITAL, http://www.bigsocietycapital.com/how-we-invest/essex-social-impact-bond (last visited May 10, 2013). Big Society Capital itself is a relative new-
Taking the SIB global is not a simple matter, however. This article explores several of the more challenging issues that are likely to arise in applying a SIB or elements of the SIB structure to social problems and development goals in developing
countries. The article begins with a summary review of the goals and structures used in the two earliest SIBs. It then discusses key challenges and opportunities that SIBs and SIB-like structures are likely to present to public and private stakeholders. Finally, the article focuses on what is needed to take SIBs to developing countries and discusses two modifications that could be made to the basic SIB structure to address possible political risks arising in a developing country context—eliminating the host country as the SIB payor and/or embedding credit enhancements into the SIB structure. It concludes with a discussion of a possible variation on the SIB structure, a new social finance innovation called the Social Impact Performance Guarantee ("SIP Guarantee"). The SIP Guarantee, as contemplated here, would realign SIB risks so that private investors/guarantors assume the performance risk of the key private actors, while public investors/lenders assume the performance and financial risk of the key public actors.

II. EARLY SIBS

A. Structures of the Early SIBs

The two earliest SIBs, launched in Peterborough, England in 2010 and New York City in 2012, are structured as contractual arrangements that seek to align public and private stakeholders' financial interests around the funding of multiple social service providers to prevent certain social problems. This focus on funding social services that are expected to prevent, rather than remedy, a problem is a hallmark of both of the early SIB structures.\(^8\)

While SIBs can be structured in different ways, one basic SIB structure, as used in the Peterborough SIB, includes the following actors:

1. a government contracting authority that is willing to engage in a pay-for-success contract under which it will pay fees upon receiving evidence of measurable improvements in preventing a defined social problem;

\(^8\) As Nick Hurd, Minister for Civil Society, U.K. recently noted, "Social [i]mpact [b]onds are opening up serious resources to tackle social problems in new and innovative ways. It is particularly good in the areas of prevention and early intervention, which are difficult to fund across government departments." Wintour, supra note 7.
2. social service providers that can demonstrate credible success in tackling the social problem that is to be the focus of the SIB;

3. private investor(s) that are willing to put at risk not only potential financial returns but also some or all of the principal amount of their investment if the target goals of the pay-for-success contract are not achieved;

4. an intermediary that: (i) borrows money from the private investor(s), (ii) distributes the SIB loan proceeds to the social service providers for use in expanding their services, and then (iii) over the life of the SIB arrangement, monitors and provides general oversight with respect to the SIB’s overall performance and directs the flow of funds among the social service providers, SIB investors, and contracting government authority; and

5. an independent evaluator that determines whether the target outcomes have been achieved in accordance with the government’s pay-for-success contract.

Exhibit A diagrams the basic structure of the Peterborough SIB.9

9. Some commenters suggest that there are two distinct evaluator roles to be included in a SIB structure: 1) an evaluation advisor that helps define performance targets, designs assessment approach, monitors progress during life of SIB and analyzes interim assessment results as part of a SIB management team so as to help guide corrective action when/if necessary; and 2) an independent assessor that works on an arm’s length basis from all of the other SIB parties, and reports on whether SIB targeted outcomes have been met. See McKinsey & Co., From Potential to Action: Bringing Social Impact Bonds to the U.S. 41 (2012), https://mckinseyonsociety.com/downloads/reports/Social-Innovation/McKinsey_Social_Impact_Bonds_Report.pdf.

In the Peterborough SIB, the social objective is to reduce prisoner recidivism in Her Majesty's Prison Peterborough in the United Kingdom. Seventeen philanthropists and other investors provided £5 million (around $8 million) of upfront capital in the form of debt finance to Social Finance, a not-for-profit organization that is acting as this SIB's intermediary. Social Finance in turn provided the proceeds of these loans as

11. The stated aim of the Peterborough SIB is to provide "intensive support to prisoners and their families, both inside prison and after release, to help them resettle into the community." Press Release, Soc. Fin., Overview of the Peterborough Social Impact Bond (2011) [hereinafter Peterborough SIB Overview], available at http://www.socialfinanceus.org/sites/socialfinanceus.org/files/SF_Peterborough_SIB_0.pdf.

12. Most of the seventeen Peterborough SIB investors are charities or foundations, such as Barrow Cadbury Trust, Esmee Fairbairn Foundation, Friends Provident Foundation, The Henry Smith Charity, Johansson Family Foundation, LankellyChase Foundation, The Monument Trust, Panahpur, Paul Hamlyn Foundation and Tudor Trust. Emma Disley et al., Lessons Learned From the Planning and Early Implementation of the Social Impact Bond at H.M.P. Peterborough 23 (2011), http://www.rand.org/content/dam/rand/pubs/technical_reports/2011/RAND_TR1166.pdf. Several "high net worth" individuals also invested in the Peterborough SIB. Id. at n. 41. Some of the Peterborough SIB investors had not previously invested in criminal justice programs—so, at least in this particular Peterborough SIB, the SIB structure catalyzed new investors to invest in the area of criminal
working capital to One Service, a not-for-profit organization set up in 2010 by Social Finance to provide a comprehensive reentry program for prisoners. If the social services interventions succeed in meeting specified performance outcomes—significant reductions in the current prisoner recidivism rate—as assessed by an independent party, the government will pay a return that includes the principal amount invested by the SIB investors together with a capped, sliding success fee. The amount of this sliding success fee will depend on the extent to which the performance outcome targets are achieved. If the performance outcome targets are not met, however, the government will have no payment obligations and, consequently, the SIB investors will lose their entire investment.

justice and offender rehabilitation. Id. at x. Whether other SIBs also can attract investors to invest in a new issue area remains to be seen. See id at 50. See generally About ONE, ONE SERVICE, www.onesib.org (last visited Apr. 7, 2013). Funding from the Peterborough SIB is directed through the One Service program, which in turn has contracted with a group of experienced social service providers that includes St. Giles Trust (which provides support to offenders in the host prison, at the prison gates, and in the community), Ormiston Trust (which provides support to prisoners' families while the offenders are in prison and after release), an organization called Supporting Others through Volunteer Action, and the YMCA (which provides a community base of support), as well as other social service providers that may be identified for additional funding in the future. Peterborough SIB Overview, supra note 11.

Sixty percent of short-sentence prisoners (i.e., those sentenced to one year or less in prison) in the U.K. re-offend within one year of release from incarceration. Peterborough SIB Overview, supra note 11.

The Peterborough SIB has an eight-year term with payments to SIB investors, if due, occurring approximately in years four, six, and eight. A New Tool, supra note 10, at 9.

For a further discussion of performance measurements, see infra notes 17-21.

The Peterborough SIB investors will be paid only if there is a measurable reduction of at least 7.5% in the frequency of reconviction events for 3,000 male prisoners sentenced to one year or less as compared to a control group of other short-sentence prisoners in the U.K. See Peterborough SIB Overview, supra note 11. The frequency of reconviction events will be measured across all short-sentence offenders released from incarceration in Peterborough, not just those who enjoy SIB-funded social services. Disley et al., supra note 12 at 35. The frequency of reconviction events is being used as a proxy measure. While this measure is likely to underestimate the actual number of re-offenses, it is expected to have a close correlation to the costs incurred by the criminal justice system as a result of re-offenses. See id. at 33,
Measuring the achievement of SIB performance targets for purposes of determining the amount of the SIB success fee can be challenging. In the Peterborough SIB, for example, the relatively small number of prisoners involved poses a risk of statistical sampling error in measuring performance outcomes. As a result, it is expected to take three to four years from the date of the initial SIB investment before any payments will be made to SIB investors. This is because it will take time to demonstrate the statistical validity of the targeted performance outcomes for the Peterborough SIBs. In future SIBs, where there are bigger sample sizes to measure, it should be easier and faster to demonstrate the statistical validity of performance targets. If improved outcomes can be demonstrated and measured earlier, then SIB outcome payments can be made sooner. Moreover, if SIB outcome payments can be

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n. 58. Note that the Peterborough SIB measures the “frequency” of reconviction, not the more binary calculation of whether any reconviction takes place. See id. at xi, 33-38.

18. The relatively small number of prisoners involved in the Peterborough SIB poses several significant challenges, the first of which is a sample size issue. Having such a small sample of data points means that there is a risk of creating false positives through sampling error. The Peterborough SIB essentially places this risk of sampling error on the SIB investors rather than on the host government, thereby reducing the risk that the Ministry of Justice would pay for an outcome that may not have been caused by the SIB intervention. See id. at 37. As a result, if there is less than conclusive evidence of the targeted performance outcomes of the Peterborough SIB (defined here as less than a 10% reduction in reconviction rates for each cohort of approximately 1,000 offenders being measured, or less than a 7.5% reduction in reconviction rates across all 3,000 offenders as compared to other short sentence prisoners in the U.K.), the Peterborough SIB investors will lose all of their SIB investments. Id. at 33-34. On the other hand, if there is a reduction of at least 10% per cohort or 7.5% overall in these reconviction rates, then the Peterborough SIB investors will receive a fixed sum per reduced reconviction event. Id. at 3. The overall value of the outcome payments is expected to generate an annual internal rate of return of between 7.5% and 13% depending on the scale of reduction in reconviction events and subject to a cap imposed by the Ministry of Justice on the total amount of outcome payments. Id. at 40.

19. Id. at 37.

20. Id. at 41.

21. The first outcome payments, provided the reduced reconviction rate threshold is met, are expected to take place three to four years after the initial SIB investments. Social Finance representatives have noted that they think that three to four years may be the maximum length that SIB investors would be willing to wait for outcome payments, particularly given the illi-
made sooner, it may be possible to enlarge the circle of potential SIB investors as there is likely a limited number of investors who are willing to offer such patient capital.\textsuperscript{22}

As noted previously, the social service providers funded with proceeds of the Peterborough SIB have proven track records of success in delivering their respective contracted social service interventions.\textsuperscript{23} By limiting the Peterborough SIB funding to proven social service providers and interventions, the execution risk being shouldered by SIB investors is primarily that of whether the contracted social services aimed at reducing prisoner recidivism can be scaled, rather than the execution risk of whether these particular social service providers can reduce prisoner recidivism. That is not to say that scaling a proven social service provider and its programs is risk-free. Many a provider of services has stumbled when trying to grow small-scale success into something larger.\textsuperscript{24}

Like the Peterborough SIB, the New York City SIB is aimed at reducing prisoner recidivism and does so by providing funding to scale preventive social interventions.\textsuperscript{25} The intermediary in the New York City SIB is the MDRC, a non-profit organization that has entered into a pay-for-success contract with the City of New York’s Department of Corrections.\textsuperscript{26} The proceeds of this SIB arrangement are being used to fund the implementation of a program called the Adolescent Behavioral Learning Experience (“ABLE”).\textsuperscript{27} Like the Peterborough

\textsuperscript{22} See generally Disley et al., supra note 12, at 38-41. Other researchers have suggested that the maximum investment horizon of a SIB is four to six years. See id.; McKinsey & Co., supra note 9, at 51.

\textsuperscript{23} See supra note 13; Peterborough SIB Overview, supra note 11.

\textsuperscript{24} See infra note 57 (discussing challenges of scaling microfinance).

\textsuperscript{25} New York City announced the first SIB in the United States on August 2, 2012. NYC SIB Press Release, supra note 2. Nicknamed “Rikers Bonds” after the Rikers Island Correctional Facility, the New York City SIB focuses on the 50% re-incarceration rate of youthful offenders in New York City. Id.

\textsuperscript{26} Id.

\textsuperscript{27} Two non-profit groups, the Osborne Association and Friends of the Island Academy, have been contracted to provide interventions in the form of education, intensive training, and counseling to the adolescent offenders that are the target of this SIB. NYC SIB Press Release, supra note 2. The Vera Institute of Justice has been contracted to act as the independent evaluator to assess the re-incarceration rates and overall effectiveness of the ABLE program. Id.
SIB, this SIB also has a performance hurdle that must be met before any SIB payments are required to be made by the government contracting authority. Namely, the re-incarceration rate of youthful offenders at the Rikers Correctional Facility must be reduced by at least ten percent from its historical rate.\textsuperscript{28}

The New York City SIB is structured differently from the Peterborough SIB, however, in several important ways. Unlike the Peterborough SIB, there is only one SIB investor in the New York City SIB: Goldman Sachs Bank.\textsuperscript{29} The MDRC is borrowing $9.6 million from Goldman Sachs in the form of a multiple-disbursing loan that is to be repaid at the end of the fifth year if the overall performance targets are met.\textsuperscript{30} The New York City SIB is also unlike the Peterborough SIB to the extent that it enjoys a credit enhancement in the form of a partial guarantee being provided by Bloomberg Philanthropies. This guarantee is being given in the form of a grant of $7.2 million from Bloomberg Philanthropies to the MDRC to be held in a guarantee fund to backstop the Goldman Sachs loan.\textsuperscript{31} As a result, Goldman Sachs enjoys the potential upside return of success fees, yet Goldman Sachs is also protected, in significant

\textsuperscript{28} The outcome payments to be made by the City of New York's Department of Corrections are structured on a capped sliding scale based on how much re-incarceration rates are reduced from historical rates at the Rikers Correctional Facility. \textit{Id.} The re-incarceration rate of youthful offenders (aged 16-18) must drop by at least 10% of the historical rate before any payment obligation is triggered under this SIB. If the re-incarceration rate for youthful offenders at Rikers Correctional Facility drops by more than 10%, then the City of New York's Department of Corrections will pay additional success fees up to a capped limit. \textit{Id.}


\textsuperscript{30} This staggered, conditional disbursement schedule should also help to protect the SIB investment being made by Goldman Sachs since it permits Goldman Sachs to stop making loan disbursements if interim targets are unmet. \textit{Id.} (explaining that the Goldman Sachs loan is to be disbursed over four years on a quarterly basis, subject to the achievement of specified impact targets).

\textsuperscript{31} NYC SIB Press Release, \textit{supra} note 2.
part, from downside risk by the credit guarantee provided by Bloomberg Philanthropies.\textsuperscript{32} Should the New York City SIB performance targets be missed, the MDRC is not required to pay anything to Goldman Sachs beyond the guarantee funds provided by Bloomberg Philanthropies.\textsuperscript{33} On the other hand, if there are any guarantee funds remaining after this first New York City SIB, the MDRC can retain those funds to support future SIBs.\textsuperscript{34} This opportunity to roll the Bloomberg Philanthropies guarantee from one successful SIB to another provides an incentive for the MDRC to ensure that the SIB's performance targets are met so that the MDRC can use these guarantee funds to support future SIB transactions.\textsuperscript{35}

Notice that it is quite a stretch to call either of these early SIBs "bonds."\textsuperscript{36} Rather, the two earliest SIBs have more in common with bridge finance as the loans being made by the SIB investors are intended to "bridge" the gap between 1) the near-term, working capital needs of a group of social service providers that have been chosen to provide designated social services pursuant to a government pay-for-success contract and 2) the longer-term government payments to be made, if any, on that pay-for-success contract. Notice, also, that these two SIBs offer their investors the least attractive features of both debt and equity. They have all the upside of debt (relatively low, capped returns) and all the downside of equity (relatively

\textsuperscript{32} If the re-incarceration rate drops by more than 20% of the historical level, Goldman Sachs will receive a return of $2.1 million. Alternatively, if the recidivism rate does not drop by at least 10% from the historical level, then Goldman Sachs could lose up to $2.4 million (after taking into account guarantee payments of $7.2 million). Chris Francescani, \textit{New York Tests Social Impact Bond Investing with Goldman Sachs}, \textit{REUTERS} (Aug. 2, 2012), available at http://www.reuters.com/assets/print?aid=USBRE8711420120802; see also \textsc{Godeke & Resner}, \textit{supra} note 29, at 22.

\textsuperscript{33} \textsc{NYC SIB Press Release, supra} note 2.

\textsuperscript{34} \textsc{Godeke & Resner, supra} note 29, at 22. See also discussion \textit{infra} notes 88-98 and accompanying text of how rolling guarantees might be tapped for greater use in SIB transactions.

\textsuperscript{35} \textsc{Godeke & Resner, supra} note 29, at 22.

\textsuperscript{36} \textit{See generally} McKinsey \& Co., \textit{supra} note 9, at 13; \textsc{Godeke & Resner, supra} note 29, at 5 (arguing that the term "social impact bond" is a misnomer for early SIBs, which do not share typical bond features such as scheduled principal payments, designated interest rates (or coupons), and ease of transfer in secondary market); \textit{see also} \textit{A New Tool, supra} note 10, at 14 (explaining how SIBs differ from municipal bonds and other fixed-income instruments used for infrastructure projects).
high risks of nonpayment). Not exactly the traditional pairing of risk and return that most investors seek. Yet SIBs are generating a growing amount of excitement and attention.

37. See id. (explaining that SIBs share features of both debt and equity—like debt, they offer fixed terms and capped upside, but, like equity, returns vary according to performance—so that, compared to more typical debt instruments, SIB investors bear greater risk of losing all of their investment).


B. Interest in the Early SIBs

Why are SIBs creating such a buzz? Part of the answer is that SIBs represent a new way to harness private capital to support the scaling of government contracted social service interventions. By tapping private sources of capital for the upfront funding needs of scaling social service providers, SIBs also introduce market accountability and oversight into the performance measurements applied to government contracts. Another reason for the excitement generated by SIBs is that these financial arrangements present a starkly different value proposition from the financial and social return tradeoffs that can accompany other forms of investments “intended to create positive impact beyond financial return”—also called “impact investments.”

39. Instead of creating impact investment opportu-
nities that ask investors to trade lower financial returns for higher social returns or, alternatively, to trade lower social returns for higher financial returns, SIBs not only correlate financial and social returns, but they make financial returns dependent on the amount of social returns being generated by the investment. Thus, the more successful a SIB is in achieving its targeted social performance outcomes, the more financial returns are generated for SIB investors.

Another part of the answer is that SIBs can provide a compelling focal point for spurring coordination among a broad range of stakeholders (governments, donors, private sector investors, and non-governmental social service providers) that are interested in scaling social service prevention interventions for a sustained period of time. In this regard, SIBs are particularly well suited to tackling those social problems that require multiple forms of intervention by a variety of social service providers because SIB structures lend themselves well to directing significant flows of funds to a group of social service providers (rather than just one-off investments in a particular provider). SIBs can also be a means of focusing sustained attention on a social problem, because the SIB structure requires a relatively long-term funding stream, rather than a series of short-term contracts. The SIB linkage of financial returns to outcome-based measurements can also help governments grow the amount of private resources available to pay for high-quality social service interventions while reducing the amount of public resources spent on poorly performing social service interventions. As one commentator succinctly

40. This goal is not without controversy, however. Some critics see SIBs as a means to privatize social objectives. They worry that governments may use SIB structures to avoid paying for needed social programs. Les Whittington, *Feds Introduce Controversial “Social Impact Bonds” to Fund Social Services, The Star* (Toronto), Nov. 8, 2012, http://www.thestar.com/news/canada/2012/11/08/feds_introduce_controversial_social_impact_bonds_to_fund_social_services.html ("critics say the bonds privatize social objectives in a way that gets governments and the public off the hook for paying for needed
(but perhaps overly optimistically) notes, "SIBs signify a new paradigm of public-private partnerships in the wake of the financial crisis, one that privatizes the risks and shares the gains." Thus, SIBs can help governments capture financial savings by investing in preventive social service interventions rather than incurring the future costs of more expensive remedial programs.

In sum, the SIB is a new form of public/private financial partnership that, if structured properly, has the potential to align the financial interests of multiple private and public stakeholders so as to:

1. Encourage private sector investors to provide long-term risk capital investments in social services programs/interventions that have a proven (or nearly proven) capacity to reach sizeable scale;

2. Apply market discipline and accountability to pay-for-success government contracting and/or development assistance by aligning incentives for funding and repayment around the achievement of specified social service outcomes; and

3. Provide a funding mechanism for delivering sizeable amounts of upfront, working capital in a coordinated and sustained manner to multiple, complementary social service providers so that the performance outcomes of their collective interventions can be harnessed and scaled more efficiently and effectively.

Other critics, like David Macdonald, a senior economist at the Ottawa-based Canadian Centre for Policy Alternatives, go even farther and argue that SIBs represent "a commercialization of social values."41

41. A New Tool, supra note 10, at 22.

42. It is unclear how important it is to governments that they actually realize these savings. It is likely that governments will have a range of motivations for participating in social impact bonds, and very possibly competing expectations and motivations may lodge within the same government. Some government officials are likely to participate in SIBs only if quantifiable financial savings can be captured as a result of the social service being provided at a larger scale. Others, however, may embrace SIBs based on the scale of social impact being delivered. Still others may expect both to occur—sizeable savings to be realized, and sizeable social impacts to occur.

43. Social service providers could try to raise this working capital on their own, of course. The challenges associated with this approach are two-fold. First, as some of these social service providers are likely organized as not-for-profit organizations, there are often constraints on the amount of capital (debt and/or grants) that they can raise in order to scale significantly. (Note
C. Differences Between the Early SIBs and Traditional Performance-Based Government Contracting

What makes a SIB arrangement different from traditional performance-based government contracts? First, in a performance-based government contract, payments are typically triggered by the creation of designated performance "outputs" rather than the achievement of designated performance "outcomes." So, for example, one performance "output" of a SIB that is focused on prisoner recidivism could be an increase in the number of prisoners receiving training in marketable trade skills to improve employment opportunities upon their release from incarceration, whereas one performance "outcome" would be a reduction in the rate of reconvictions taking place among the targeted prisoner population.

Second, even where the government contract is structured as a "pay-for-success" contract, so that it pays upon the successful achievement of performance outcomes rather than outputs, the financial risks generally are allocated between just two parties—the host government and its contractors. By that McKinsey researchers assumed that not-for-profit organizations would be the leading providers of preventive interventions for homelessness and prisoner recidivism. See McKinsey & Co., supra note 9, at 19.) Second, for thorny social problems like recidivism and homelessness, it is unlikely that one social service provider can deliver all the program interventions that are needed to reach a successful outcome. This creates need for a "collective action" response mechanism whereby a number of social service providers can scale their activities collectively. Coordinating this kind of funding on a provider-by-provider basis is likely to be very difficult. Hence, there is a need for a funding mechanism like the SIB that generates capital that can then be delivered to multiple social service providers.

44. Some commenters are careful to distinguish between "pay-for-performance" and "pay-for-success" contracts. See Godeke & Resner, supra note 29, at 5 (explaining that pay-for-performance contracts pay for achievement of performance outputs, in contrast to pay-for-success contracts, which pay for performance outcomes); see also A New Tool, supra note 10, at 13 (explaining that SIBs differ substantially from government performance-based contracts for social services).

45. How that financial risk is allocated between the parties turns on which party provides the upfront working capital. In some cases, pay-for-success contracts impose most of the financial risk on the contractors, which must secure upfront working capital from investors or other sources to fulfill the contract. Government payments then take place only after specified performance goals are achieved. In other cases, the government bears most of the financial risk by contracting to make a fixed payment to the contractor,
pairing a pay-for-success government contract with a SIB funding structure, private investors and not the host government become the source of the social service providers’ upfront, working capital. Therefore, the SIB investors bear the financial risk of the social service providers’ underperformance.

Third, by attracting longer-term financing from private SIB investors, there is also an opportunity, depending on the SIB investors’ appetite, to extend the period over which pay-for-success transactions are to be conducted and funded. Whereas traditional government sources of funding provide relatively short-term funds (for one to two years) to pay for social services, SIBs can therefore be structured to match funding maturities with much longer performance horizons.\(^6\)

Integrating SIB investors into a pay-for-success government contract has more implications than just financial risk allocation and funding maturities, however. In order to give SIB investors sufficient assurance that their investments will be protected, SIB structures can give investors, or (more likely) intermediaries acting on behalf of the investors’ interests, a much greater role in taking actions and making decisions about matters that are more typically within the purview of the contracting host government. For example, whereas traditional government contracts typically articulate the amount of funds to be expended, the type of services to be delivered, and the delivery methods to be used, SIBs can be structured so as to give private sector players more latitude to decide which services are to be delivered and which methods are to be used to achieve targeted levels of performance outcomes. Similarly, government procurement processes typically give government officials the ultimate decision-making authority regarding which social service providers to fund and whether to replace underperforming social service providers. SIBs, however, may delegate much of this authority to private sector players, such as the SIB intermediary, who have a financial or, at the very

\(^6\) There is likely to be a limit, however, to how patient SIB investors will be. Requiring SIB investors to wait three to four years from the date of their initial SIB investment for an outcome payment (as they must in the Peterborough SIB) may limit the types of investors that will be attracted to SIBs. See discussion at supra note 21.
least, reputational interest in seeing that the performance outcomes are achieved.\textsuperscript{47}

Sharing or explicitly delegating decision-making authority from the contracting government authority to private actors can be a challenging hurdle to the successful integration of a SIB funding structure into a pay-for-success government contract. This hurdle can take many forms—from culture to statutory impediments.\textsuperscript{48} Accordingly, there is a growing need for knowledge sharing and transparency about the effectiveness of the SIB governance models and contractual arrangements that are being developed to address this delegation of contracting

\textsuperscript{47} See Disley et al., supra note 12, at 16. The Peterborough SIB marked the development of a new type of commissioning relationship. In other pay-for-success contracts undertaken in the United Kingdom, the government typically maintains some control over the selection of social service providers. \textit{Id.} at x. In the Peterborough SIB, however, provider selection was delegated to the intermediary, Social Finance, and the government has no direct contractual relationship with the service providers. \textit{See id.} at 11-12.

\textsuperscript{48} See U.N. Comm'n on Int'l Trade Law, Legislative Guide on Privately Financed Infrastructure Projects 147-48 (2001) [hereinafter UNCITRAL LEGISLATIVE GUIDE], available at http://www.uncitral.org/pdf/english/texts/procurem/pfip/guide/pfip-e.pdf; see also Civil Law Systems—Key Terms Implied by Law that Can Impact PPP Arrangements: Rights of Contracting Authority that May Override Contractual Provisions, PPP INFRASTRUCTURE RES. CTR., http://ppp.worldbank.org/public-private-partnership/ppp-overview/practical-tools/checklists-and-risk-matrices/civil-law-systems-key-terms/civil-law-syst (last visited Feb. 25 2013) (indicating that many civil law countries have enacted administrative laws to govern public/private partnerships that may give contracting government authority rights to override public/private contractual arrangements, such as to modify or cancel such contracts unilaterally (if deemed in public interest) and rights to require continuity of service (even if the contracting government authority breaches its contractual obligations)).

In some countries, continuity of certain social services is deemed so important that service providers are required by law to ensure the continuous provision of service. Moreover, in legal systems where this statutory duty exists, it is not unusual also to find that, while general principles of contract law might authorize a party to suspend/discontinue performance of its obligations, perhaps due to economic hardship or material counterparty breaches, concessionaires cannot invoke those contract principles as grounds for suspending or discontinuing the provision of public services. \textit{See} UNCITRAL LEGISLATIVE GUIDE, \textit{supra}, at 129 ("In some legal systems, the contracting authority may even have special enforcement powers to compel the concessionaire to resume providing the service in the event of an unlawful discontinuance.").
authority from host governments to SIB investors or SIB intermediaries.

III.
GROWING THE SIB ECOSYSTEM: CHALLENGES AND OPPORTUNITIES

At this early stage in the evolution of the SIB, the end game of this new type of public/private partnership structure is hard to pin down. As each new SIB is transacted, there are likely to be refinements made in the SIB structure to reflect the needs of all stakeholders involved—governments, social service providers, SIB intermediaries, and SIB investors—and to reflect local circumstances and relationships. The likelihood of refinements reinforces the need for those participating in early SIB arrangements to engage in what at least one commenter has termed "high value learning,"\(^4\) so that the lessons of both successful and unsuccessful SIB structures can be shared broadly and quickly. In the interim, while we wait to see how well these first SIBs work, it is worth surveying the challenges that have confronted more traditional public/private partnerships to glean lessons that could be applied to SIBs.

As noted above, SIB structures have much in common with private, infrastructure project financings as these two funding structures create opportunities to reduce the commitment of public funds and resources, while increasing private sector funding. Like privately financed infrastructure projects, SIBs make it possible to transfer to the private sector a number of risks that otherwise would be borne by the host government. Accordingly, appropriate risk allocation is just as essential in SIB arrangements as it is in more traditional, privately financed infrastructure projects.

SIB risks can come in many flavors. One commenter has grouped these risks under the following categories: "intervention model, execution, intermediary, political, financial, and reputational risks."\(^5\) The allocation of these risks among the various parties to SIB arrangements is likely to be shaped by


\(^5\) See A New Tool, supra note 10, at 20-22.
factors such as the public interest in scaling the social sector services in question, the level of risk faced by the private players, and the extent of the private players' ability (and readiness) to absorb those risks at an acceptable cost. Relatedly, as in infrastructure projects, inappropriate allocations of project risks can compromise the SIB's financial viability and efficient management. So, just as in privately financed infrastructure projects, every discussion of adopting a SIB structure should be accompanied by 1) a hard-headed assessment of the potential severity of the risks involved should a SIB arrangement going awry and 2) a transfer of those risks to the party or parties in the best position to manage or mitigate them. The categories of risk named above are considered in turn.

A. Intervention Model Risk

Intervention model risk refers to the risk that the chosen social service interventions do not produce the expected outcomes. Limiting SIB funding to proven, as opposed to promising, social service interventions is one important way to address this risk. Moreover, not every social service intervention, even if proven, can (or should) be scaled through a SIB funding structure. Perhaps most obvious, some important social services do not have outcomes that are easily measured. For example, a SIB funding structure is not likely to be appropriate for social service interventions that reach such a small number of people that it is impossible to measure with any statistical certainty the impact of the SIB on that target population. Nor is a SIB a good funding source if the social service providers likely to receive the SIB funding are not able or ready to grow to scale without damaging the quality of the services being offered. Over time, however, as more SIB transactions take place, a clearer understanding should emerge of the types of social service interventions that are best suited to SIB structures.

51. Id. at 20.
52. See McKinsey & Co., supra note 9, at 19 (explaining that SIBs are for scaling proven interventions, and SIBs used for scaling promising but not proven interventions carry both execution risk and model risk).
53. See id. at 25 (maintaining that SIB-funded interventions must focus on prevention, have a multi-year track record (at least five years), have demonstrated a record of vigorous evaluations, deliver statistically significant
B. Execution Risk

Execution risk is closely related to intervention model risk because it encompasses the performance challenges that are unique to the SIB structure and goals as well as the performance challenges that one often encounters in project financing.\textsuperscript{54} The most obvious execution risk in a SIB structure is that posed by the social service providers. Although a particular social service intervention may have been well chosen, the social service providers responsible for scaling that intervention may prove to be weak or otherwise unable to scale the intervention as expected.

Conducting adequate due diligence with respect to the social service providers that are to receive SIB funding is one way to manage this form of execution risk.\textsuperscript{55} At a minimum, this means paying attention to whether the social service providers to be funded by a SIB have a proven track record of success in delivering the targeted social service interventions and of working effectively with other social service providers. It also means assessing whether the social service providers have the capacity (leadership talent, staff, governance, management information systems, quality controls, back-office systems, etc.) to grow to scale without sacrificing the quality of their services.

Even the best due diligence, however, has its limitations when it comes to predicting how well social service providers can absorb and put to good use the relatively large amounts of working capital that a SIB structure is intended to generate. Accordingly, another way to manage this form of execution risk is to develop a robust ecosystem of support for social service providers that are likely to become beneficiaries of SIB funding. Building "investment ready" social service providers is important not only for the success of SIB structures, of course, but also for any concerted effort to bring social services to greater scale.

A second SIB execution risk is the risk that a well-conceived but badly executed SIB could wreak havoc on the very populations that the SIB is meant to serve. For example, the private sector players that are funding, contracting, and/or

\textsuperscript{54} Id. at 21.
\textsuperscript{55} Id. at 20.
implementing social services interventions could simply give up on the SIB arrangement if it does not meet performance objectives within the SIB investors' expected investment horizon and, therefore, shut down the SIB arrangement, perhaps prematurely. In turn, this could strand vulnerable populations that are relying on the very social services that the SIB was set up to scale. Some have suggested that the severe consequences of such "shut down" risk means that SIBs should not be used to scale core social services.56

Core or not, social services that are the object of SIB funding likely will need to be insulated from execution/performance and financial failures of SIB arrangements. At a minimum, contingency plans should include strategies for responding to missed performance targets, underperforming social service providers, and funding failures.57 Alternatively, SIB parties might address this concern contractually by offering "step in" rights to the government contracting authority or the SIB intermediary. These step-in rights would authorize the government contracting authority or the SIB intermediary, acting on behalf of the SIB investors, to "step in" to deal with and fix things in place of the originally contracted social service providers in order to ensure that important services continue to be delivered.58

A third execution risk to the target beneficiaries of a SIB structure is that of inappropriate actions being taken by social service providers in order to ensure that they meet the SIB performance targets. These actions, in turn, might subvert the very social objectives that the SIB seeks to advance. For example, a social service provider participating in a SIB aimed at reducing the number of children residing in foster care might start returning children to dangerous family situations without sufficient regard for the children's safety. Or a social service provider participating in a SIB aimed at prisoner recidivism might interfere with legal processes to ensure that reconvic-

57. Id. at 25.
58. See UNCITRAL LEGISLATIVE GUIDE, supra note 48, at 147-48 (explaining that government contracting authority's "step in" rights typically relate to specific, temporary, and urgent service failures, while lenders' "step in" rights tend to be triggered by recurrent failures of a concessionaire or by failures regarded as irremediable).
tion rates are delayed or inappropriately frustrated during periods when SIB reconviction targets are to be measured.\textsuperscript{59}

This execution risk can be addressed in several ways. For example, the host government can 1) require that rigorous due diligence be conducted regarding the financial incentive schemes, codes of conduct, staff training, and reputation of all selected social service providers, 2) include provisions in its contract with the SIB intermediary that provide for possible termination or replacement rights by the host government and/or the imposition of stiff financial penalties should a pattern of inappropriate actions by social service providers (or their staffs) be discovered, and 3) support the establishment of independent watchdog organizations whose function is to make sure that vulnerable populations affected by SIB-funded

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\item[59.] If either of these scenarios seems like a remote possibility, then it may be worth reflecting on the challenges that the microfinance sector has faced in recent years. Fuelled by growing amounts of private investor capital, some microfinance institutions rapidly scaled the financial services they offered to very poor individuals, only to find that some of those scaling efforts were marked by inadequate customer protection safeguards. As a result, far from pulling people out of poverty, some of these financial service providers appear to have turned a blind eye to the growing debt burden faced their target clientele. An influx of working capital and aggressive growth targets caused some fast growing microfinance institutions to experience weaknesses in the quality of their microcredit portfolios and, related, inappropriate behavior toward clients. See \textsc{Greg Chen et al.}, CGAP, \textit{Growth Vulnerabilities in Microfinance} 9-11 (Feb. 2010), \url{http://www.cgap.org/sites/default/files/CGAP-Focus-Note-Growth-and-Vulnerabilities-in-Microfinance-Feb-2010.pdf} ("[U]nder pressure to meet targets and with limited supervisory oversight, frontline staff occasionally resort to unsavory collection practices . . . "); CGAP, \textit{Andhra Pradesh 2010: Global Implications of the Crisis in Indian Microfinance} 5-6 (Nov. 2010), \url{http://www.cgap.org/sites/default/files/CGAP-Focus-Note-Andhra-Pradesh-2010-Global-Implications-of-the-Crisis-in-Indian-Microfinance-Nov-2010.pdf} (rapid expansion and growth in microfinance portfolios can undermine credit discipline, thereby leading to "unhealthy rises in loan amounts, cutting corners in the underwriting process, and resulting in an excessive supply of credit. Incentives at the field level are often based solely on disbursements and collection volumes, with insufficient incentives for sound underwriting or customer care."); see also CGAP, A \textit{Guide to Regulation and Supervision of Microfinance: Consensus Guidelines} 52, 55-56 (Oct. 2012), \url{http://www.cgap.org/sites/default/files/Consensus-Guideline-A-Guide-to-Regulation-and-Supervision-of-Microfinance-Oct-2012_0.pdf} ("[R]apid growth in credit markets that approach saturation can lead to over-lending and other behaviors that are not in best interest of customers . . . ").
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Interventions are adequately protected and appropriately treated.

SIB investors are also likely to be concerned about this risk as it can damage both the social and the financial returns on their SIB investments, as well as their reputations. They too can take steps to influence SIB arrangements to avoid inappropriate behavior: 1) before an investment, through their decisions about whether to invest in a particular SIB (including due diligence as to the SIB intermediary, the likely social service providers, and their potential fellow SIB investors) and 2) once invested, through the influence they exert on the governance of the SIB intermediary.

C. Intermediary Risk

Intermediary risk is another kind of risk that is likely to be of concern to host governments and SIB investors. This is the risk that the SIB intermediary will fail to perform its obligations, which in turn would frustrate the achievement of the SIB’s social and financial goals. As SIB structures evolve, it is likely that the role of SIB intermediaries may also shift or be tailored to a given circumstance. In some SIBs, SIB intermediaries may act very proactively, much like private equity fund managers. In other SIBs, SIB intermediaries may function more like passive trustees or fiscal agents. Intermediary risk, therefore, can take several forms.

First, SIB intermediaries might not be up to the task of coordinating and managing the complicated web of actors and interests inherent in a SIB arrangement throughout the life of the SIB investment. 60 Given the novelty of the SIB structure, this is a present danger; there is no track record in SIB intermediation. As a result, many of those offering SIB intermediation services today, while able to demonstrate proven financial and management skills, are learning on the job.

A second intermediary risk is that of a SIB intermediary failing for reasons unrelated to its SIB roles and responsibilities. This is a risk most likely to occur with SIB intermediaries that have other financial and operational responsibilities, in addition to their SIB activities. One way to protect against this risk is to establish a special purpose vehicle with its own man-

agement team to house the SIB intermediary function so as to protect the assets of the SIB intermediary from other financial claims or to avoid the distractions of (and possible conflicts of interests with) other programmatic responsibilities.

As more SIB intermediary experience is accumulated, one can imagine that a consensus will emerge as to best practices in SIB governance. Drawing on such practices should also help reduce the risk of SIB intermediary failure. Similarly, as more organizations gain experience in SIB intermediation, there may be opportunities for weak SIB intermediaries to be eased out and new SIB intermediaries to be recruited. Shifts of this nature, of course, would need to be contemplated in the SIB documentation upfront, and the processes for removing and substituting a SIB intermediary would need to be agreed to by the government contracting authority as well as the affected SIB investors.

D. Political Risk

Another key SIB risk, political risk, relates to both the capacity and the will of the host government to undertake its obligations under a SIB structure and, equally importantly, not to hinder others from meeting their respective SIB obligations. This political risk can manifest itself in many ways, including interference with SIB measurement tools, forced renegotiation of SIB contractual terms, manufactured delays (or the creation of other obstacles) to passing appropriate authorizing legislation to permit the government to meet its SIB obligations, or even nonpayment of SIB obligations. The relatively long duration of a SIB can exacerbate this risk as it increases the likelihood of changes in key government officials or political upheavals, as well as possible adverse shifts in economic conditions.

Moreover, the political risk inherent in SIB structures is likely to be heightened where the host government has only limited experience, if any, in engaging in pay-for-success contracting for social services. This kind of outcome-based contractual arrangement can be complex to negotiate and manage, requiring a good deal of sophistication from all parties to the arrangements, including the host government agency.
charged with administering the resulting contract. When these contractual arrangements also involve SIB funding, even greater sophistication is required of the host government.

Among the minimum abilities that host governments will need in order to conduct a SIB negotiation are the abilities to determine performance targets, to estimate the likely costs of funding interventions to reach those targets, and to calculate the performance success fees (over those estimated costs) that are likely to attract sufficient investors to fund the SIB while still preserving savings for the host government. It is unlikely that many government agencies today enjoy this kind of expertise in house. Therefore, host governments will be heavily reliant on outside experts, many of whom, at least initially, may also be structuring and negotiating SIB arrangements for the first time. Training host government representatives in the legal, policy, and business issues raised by SIB arrangements could help ensure a more level playing field for host governments that are negotiating their first SIBs. Developing resource banks of SIB documentation and other related SIB toolkits for use by host governments is another step that would help ensure that governments are in a position to conduct a SIB negotiation.

Another contributing factor to the political risks confronting SIB structures is the possibility that some SIBs may be priced inappropriately for the financial risks and returns that they are able to generate. In some SIB structures successful outcomes are likely to be realized only over the medium- to long-term (and possibly recognized only in hindsight). This can make SIBs and their sponsoring host governments vulnerable to the criticism that the SIB returns payable to investors are too rich for the risks that are being taken. In turn, this criticism can put pressure on host governments to renegotiate

62. To this end, expanding the PPPIRC’s database to include executed SIB transactions could be useful. Another useful next step would be further dissemination of annotated SIB documentation or term sheets. One early example of this latter suggestion is the draft language for SIB contracts proposed by the Center for American Progress. See Jitinder Kohli et al., Ctr. for Am. Progress, Inside a Social Impact Bond Agreement: Exploring the Contract Challenges of a New Social Finance Mechanism (May 7, 2012), http://www.americanprogress.org/wp-content/uploads/issues/2012/05/pdf/sib_agreement_brief.pdf.
the terms of SIB arrangements. One way to mitigate this risk is to build success-fee formulas for SIBs that correlate directly with the savings generated by the performance outcomes being funded. This will not be easy. Even if a SIB-funded performance outcome does generate direct budgetary savings, it may take a very long time for those savings to be realized—perhaps long after the SIB funding arrangement comes to an end.

Entrenched government interests also can pose a risk to SIBs. As noted before, SIBs bring a variety of stakeholders to the table by design. This includes a possible mix of government agencies, departments, and programs. Some of these government actors may resist the coordination and delegation of decision-making authority that SIBs require to succeed. This resistance can be overt or, perhaps more damaging, covert. It can be deliberate or it can result from weak governance or poor coordination among affected government actors. Whatever the cause of this resistance, the results can be equally devastating to the success of a SIB structure. If performance outcomes (or the measurements of such outcomes) are sabotaged, SIB investors will be rightly outraged.

This is why many of those who are structuring and analyzing SIB structures point to the critical importance of executive leadership within the host government that is sponsoring a SIB. The challenge, of course, is that political leaders change. Therefore, for SIBs to succeed beyond one government administration, there needs to be widespread support

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63. Those who have seen the upsurge in the renegotiation rates of other types of private/public partnerships may be collectively nodding their heads at this possible scenario. See e.g., Eduardo Engel et al., *Soft Budgets and Renegotiations in Public-Private Partnerships* (Nat. Bureau of Econ. Research, Working Paper Series No. 15300, August 2009), available at http://www.nber.org/papers/w15300.pdf (suggesting that government use of renegotiation to avoid budget constraints and spending caps is pervasive in public/private partnerships; in one study of 1000 such partnerships in Latin America over a 20-year span, 30% of contracts were renegotiated, with even higher renegotiation rates for certain types of projects).

64. This may explain the McKinsey recommendation that SIB-funded interventions should deliver taxpayer benefits in less than five years. See supra note 51.

65. See supra Part IIB.

66. See McKinsey & Co., supra note 9, at 35 (arguing that executive leadership within host government is a catalyst for SIB progress).
for the SIB structure from the host government at all levels and, just as importantly, from the public at large. This suggests that it will be very important to develop proactive communication strategies to ensure that not only SIB beneficiaries but also the public at large understand the benefits of the SIB structure.

Similarly, SIBs may need special authorization and appropriate legislation to ensure that the host government has sufficient legal authority to bind itself to a long-term, pay-for-success contractual obligation. The need for new laws will turn, of course, on the extent of applicable existing legal authority that the host government already enjoys and the nature of the payment obligations that the host government is undertaking within the SIB structure.

Several states in the United States are contemplating or have enacted legislation intended to advance the issuance of SIBs or SIB-like financial instruments. One of the first states to enact such legislation was Massachusetts. In 2012 Massachu-

67. For example, legislators in California are considering legislation that would offer three financing tools to engage the business sector more directly in California’s public education system. See California Career Pathways Investment S.B. 594, 2013-2014 Sess. (Cal. 2013), available at http://leginfo.legislature.ca.gov/faces/billSearchClient.xhtml. One of the SIB-like tools being considered would allow businesses to purchase “Workforce Development Bonds” that generate performance-based returns. See Id. at Legislative Counsel’s Digest. The proceeds of these Workforce Development Bonds would be used to finance “career pathways programs” currently run by existing school and community colleges. Id. This marks a departure from other SIBs as the funds raised by these Workforce Development Bonds would be directed to government entities rather than private providers of services. Kristina Costa of the Center for American Progress notes:

For governments, social impact bonds offer a way to transfer some of the financial risks involved in implementing or scaling preventive programs until they are proven successful. That benefit may be lost if different agencies or different levels of government are, in effect, working on both sides of a social impact bond.


68. While Minnesota enacted legislation even earlier than Massachusetts, the Minnesota program is very different. In 2011, the Minnesota legislature approved $10 million for a program piloting “Human Capital Performance Bonds” (“HUCAPs”), which is aimed at expanding proven workforce development programs. See Minnesota Pay for Performance Act of 2011, MINN. STAT. § 16A.93-16A.96 (2011) (authorizing issuance of state appropriation
setts passed legislation to establish a sinking fund to finance payments owed by the state on certain qualifying pay-for-success contracts. Among the qualifying features of these contracts, they are expected to result in "significant performance improvements and budgetary savings across all impacted agen-

bonds, appropriating money, establishing the Minnesota pay-for-performance pilot program and proposing coding for a new law in Minnesota Statutes). HUCAPs are very different from the SIBs being contemplated by Massachusetts, however. Investors in the Minnesota HUCAPs are taking only Minnesota State risk by purchasing a "moral obligation" bond that will earn returns commensurate with that very limited state risk. Investors in the HUCAPs are not assuming any performance risk of the social service providers; therefore, they also will not earn any extra success fees if performance targets are met. Id. Rather, the risks and returns of the social services providers not performing or under-performing in meeting the pay-for-success targets are expected to be assumed by a group of working capital funders. Id. Subsequent to its passage, a constitutional question was raised about whether this legislation contravened the Minnesota State Constitution. On October 31, 2012, the Minnesota Supreme Court ruled that the HUCAP legislation did not run afoul of the state constitution. See generally Rob Gurwitt, In Massachusetts, Mobilizing Private Investment for Public Good, STATELINE (Nov. 14, 2012), available at http://www.pewstates.org/projects/stateline/headlines/in-massachusetts-mobilizing-private-investment-for-public-good-85899430072.

69. On July 8, 2012 the State Legislature of Massachusetts approved passage of an act that sets up a trust fund to finance payments owed by the State of Massachusetts on "pay for success contracts." MAS. GEN. LAWS ch. 10, § 35VV. This legislation expressly authorizes the secretary of administration and finance to enter into pay for success contracts that have the following features:

(1) a requirement that a substantial portion of the payment be conditioned on the achievement of specific outcomes based on defined performance targets; (2) an objective process by which an independent evaluator will determine whether the performance targets have been achieved; (3) a calculation of the amount and timing of payments that would be earned by the service provider during each year of the agreement if performance targets are achieved as determined by the independent evaluator; (4) a sinking fund requirement under which the secretary shall request an appropriation for each fiscal year that the contract is in effect, in an amount equal to the expected payments that the commonwealth would ultimately be obligated to pay in the future based upon service provided during that fiscal year, if performance targets were achieved; and (5) a determination by the secretary that the contract will result in significant performance improvements and budgetary savings across all impacted agencies if the performance targets are achieved.

Id. at § 35VV(b).
cies if the performance targets are achieved.”

The legislation further authorizes the Massachusetts secretary of administration and finance to provide that Massachusetts's payment obligations under these pay-for-success contracts are to constitute "a general obligation of the commonwealth [of Massachusetts] for which the full faith and credit of the commonwealth shall be pledged for the benefit of the providers of the contracted government services" up to an aggregate amount of $50 million.

E. Financial Risk

In these early SIB days, the financial risks posed by SIBs are largely borne by the SIB investors. This has limited the pool of those interested in investing in SIBs. As SIB structures evolve, however, other financial risk-mitigation and risk-sharing tools, such as credit enhancements that provide external collateral or support senior investment tranches in the capital structure of the SIB, could be incorporated into the SIB structure. As a result, the pool of possible SIB investors may expand. Until that time, however, the financial risks posed by a SIB to its investors are exacerbated by the fact that the SIB is a relatively long-term, illiquid investment.

70. Id. at § 35VV(b)(5).

71. Id. at § 35VV(c). Recently, two more states have enacted legislation to advance SIBs or SIB-like structures. These states, New Jersey and Connecticut, appear to be taking a different legislative tack from Massachusetts. Rather than authorizing the state to be the sole payor under these SIBs, New Jersey and Connecticut appear to be looking for other funding sources to finance those obligations that come due on pay-for-success/outcome-based government contracts. In New Jersey, legislation that was passed by the Assembly in March 2013 authorizes the New Jersey Economic Development Authority, not the state, to issue SIBs in an amount not to exceed $3 million in any given year or $15 million in the aggregate over five years. N.J. Social Innovation Act, supra note 38, at 5(c).

In the spring of 2012 Connecticut passed legislation that authorizes the Office of Policy and Management secretary of the state to enter into "an outcome-based performance contract with a social innovation investment enterprise" for the purpose of accepting funding from the U.S. Department of Justice for adult reentry programs. See 2012 Conn. Acts, § 128 (June 12 Spec. Sess.) (effective date July 1, 2012).

72. See generally GODEKE & Resner, supra note 29; see also A NEW TOOL, supra note 10, at 15, 22 (predicting that mainstream investors might begin to participate in SIBs if transactions are structured to promote "creative risk sharing").
Another financial risk inherent in the SIB structure is the risk that the overall transaction costs of the SIB structure may overwhelm the financial returns to be gained in the transaction. These sizeable transaction costs, which may be shared, either directly or indirectly, with other actors in the SIB arrangement include the time and money that it takes to structure a SIB.\textsuperscript{73} These are not the only costs. Once a SIB structure has been put in place, there will be additional recurrent expenses related to managing the SIB (paid to the SIB intermediary) and measuring the performance outcomes of the SIB (paid to the SIB independent evaluator). This means that SIBs need to be relatively large in order to support their fixed and ongoing costs.\textsuperscript{74} It is likely that the first SIBs will be the most expensive to set up.\textsuperscript{75} Replication and some standardization of contracts and structures may drive SIB costs down somewhat but not a lot, particularly if different governments or different social issues (and, therefore, different performance targets) are involved.\textsuperscript{76} The challenge this presents is to find ways to lower the transaction costs of launching SIBs while still allowing for sufficient customization so that SIB structures can reflect local circumstances and particular performance targets.

\textsuperscript{73} The Peterborough SIB took approximately eighteen months to launch. \textit{See} \textsc{Disley et al.}, \textsuperscript{supra} note 12, at 10. Social Finance estimates that it invested approximately 2.5 person years of resources and more than 300 hours of legal advice (provided pro bono) to develop the Peterborough SIB. \textit{Id.} at 13. Some of the smaller investors in the Peterborough SIB worked to minimize the legal and due diligence costs involved by “piggybacking” on other larger investors’ assessments. \textit{Id.} at 13 (“We effectively took a common-sense approach and said, if it’s good enough for Esmee Fairbairn, it’s good enough for us—and did a light touch due diligence.”).

\textsuperscript{74} The Peterborough SIB is approximately $8 million; and the New York City SIB is $9.6 million. \textit{See also} \textsc{Soc. Fin., Technical Guide to Commissioning Social Impact Bonds} 11 (November 2011), http://socialfinance.org.uk/sites/default/files/technical_guide_to_commissioning_social_impact_bonds.pdf (contract size for establishing a SIB investor-owned entity, like that used in the Peterborough SIB, would ideally be over 10 million pounds to cover set up and running costs).

\textsuperscript{75} Social Finance hopes cost of capital for SIBs will decline over time as investors and markets get more comfortable. \textit{See} \textsc{Disley et al.}, \textsuperscript{supra} note 12, at 30; \textit{see also} \textsuperscript{supra} note 68.

\textsuperscript{76} \textit{See} \textsc{McKinsey \\& Co.}, \textsuperscript{supra} note 9, at 10 (arguing that SIB scaling will benefit from standardization and sharing of best practices).
F. Reputation Risk

All players in a SIB structure are vulnerable to reputation risk should the SIB transaction not succeed. Social service providers are perhaps at the front line of reputational risk since their failure to meet targeted outcomes could have far-reaching implications beyond just the SIB structure. Yet other SIB parties may suffer reputational risk too should a SIB fail.

The largest reputational risk, however, is not the damage that might occur to the reputations of a relatively small handful of SIB parties. Rather, the reputational risk that should be of greatest concern is that of the contagion risk of highly publicized SIB controversies spilling over to the marketplace more generally. For example, imagine how politically-charged criticisms of a SIB pricing structure or allegations of mistreatment of targeted SIB beneficiaries might flow far beyond a particular controversial SIB transaction to erode the political will of host governments in general to make good on their current or future SIB obligations and, ultimately, to sour the investor landscape for participating in SIB structures. Hence, as SIB structures emerge and are tested, care should be taken to identify and publicize the weaknesses found in existing SIB structures so that others can avoid duplicating those mistakes.

IV. Taking SIBs Global

All of the above are risks that SIBs are likely to encounter no matter where they are launched. Imagine the additional risks that SIB investors might face when taking SIBs to coun-

77. See A NEW TOOL, supra note 10, at 22 (pointing out that social service providers may suffer significant reputational harm which could affect donor decisions about future funding). See also DISLEY ET AL., supra note 12, at 19 (explaining that, because of intense interest of the public, Ministry of Justice, Social Finance, H.M.P. Peterborough and providers of social services all bear reputational risk of the Peterborough SIB). The director of St. Giles Trust, a service provider in the Peterborough SIB, indicates that St. Giles Trust . . . is very squarely seen as one of the key delivery agents. We've spent . . . 50 years . . . building up a reputation that we're a very robust service-delivery charity that makes a real impact on clients, so it's not so much that the financial risks I'm facing, but it's certainly reputational risk.

Id.
tries where any or all of the following factors are present: weak governance at all levels of government (federal, state, municipal), political and/or financial instability, severely limited financial resources to pay for social services of any kind, deeply marginalized citizens, and heightened vulnerability to regional and global conflicts.

Just dealing with the foreign exchange risks that a long-term SIB payment stream could present to international investors is challenging. In addition, some developing countries will realize little, if any, budgetary savings upon reaching a successful preventive outcome because their governments do not currently provide or fund related remedial social services. In instances like these, a moral hazard is embedded in the SIB structure. In short, a successful SIB will be more expensive for a host government than an unsuccessful SIB, and this fact could provide the host government with a perverse financial incentive to interfere with or sabotage the achievement of SIB performance outcomes.

Taking SIBs global, particularly to the countries and societies most in need of large-scale preventive social services, requires caution, a critical rethinking of the SIB structure, and even a possible shift in how financial incentives are aligned within SIB partnerships. Yet, because SIBs may be able to drive sizeable amounts of funding toward challenges that require a variety of interventions, they may actually be particularly well suited to addressing some of the most complex social service problems confronting many emerging markets and their vulnerable populations. Furthermore, SIBs may be able not only to take full advantage of the social finance innovations that have already been developed and are being implemented around the world; they may also be able to push these social financial innovations still further, just as SIBs are likely to be integrated increasingly into pay-for-success government contracts here in the United States.

As SIBs are brought to emerging markets, there is likely to be a wide variation in the deal structures used as parties respond to perceived counterparty risk of nonperformance (or inappropriate actions undertaken) by the host government. This article offers three possible deal structures that might be used—individually, sequentially, or in combination—to manage this risk:
1. Non-host governmental SIBs. *Limit the host government's role in the SIB transaction by using a more credible and/or financially sound development assistance organization or development finance institution as the contracting authority and, thus, as the SIB payor;*

2. Credit-enhanced SIBs. *Improve the financial viability of the SIB structure by making use of a third party credit enhancement; and*

3. Social Impact Performance Guarantees. *Shorten the duration of SIB investors' "at risk" capital by involving SIB investors primarily as guarantors, rather than funders, of the upfront, working capital to be provided to social service providers.*

Of course, these are not the only possible structural variations that could be used in a SIB structure where the capacity or will of the host government to meet its contractual obligations under a pay-for-success contract is in doubt.⁷⁸ In some cases, individual elements from one or more of these options could be included in the same SIB structure. It is also likely that the structure of SIB deals within a single country will change over time to reflect shifts in SIB investor confidence in the host government's performance of its SIB-related obligations. Accordingly, thought should be given to how SIB structural variations are sequenced within a country so as to reward performing host governments with more SIB funding over time.

A. *Non-Host Governmental SIBs*

Removing the host government from the SIB structure, at least insofar as it has any financial obligations to make SIB payments, may be the easiest and certainly the least costly of these three SIB variations.⁷⁹ For this scenario to work, however, 

⁷⁸. See generally GODDEKE & RESNER, supra note 29, for a brief discussion of government counterparty risk mitigation.

⁷⁹. This is one focus of the work of the Development Impact Bonds Working Group that the Center for Global Development has convened in partnership with Social Finance. See SOC. FIN. & CTR. FOR GLOBAL DEV., DEVELOPMENT IMPACT BONDS WORKING GROUP BRIEFING NOTE: MEETING 1-29 MAY 2012, http://www.cgdev.org/doc/Working%20Groups/Development%20Impact%20Bonds%20Briefing%20Note.pdf (explaining that while the development impact bond structure is a variation on the SIB structure, among other differences, development impact bond could look to donors, host
there would need to be another, more credible source of payment for SIB investors. That could be where development assistance organizations and development finance institutions step into the SIB structure and the host government steps out. Some development agencies are likely to find this approach appealing on policy grounds, as well as on financial grounds, since the development funding that they allocate to supporting a SIB would be used only for interventions that "work" (as measured by the SIB performance targets), thereby allowing them to avoid paying for failed interventions.

There are, however, several downsides with this approach. The first downside, and possibly the most unlikely, is that this approach becomes too successful, leading to public pressure to "privatize" much of the costs of development assistance through widespread use of SIB transactions. As was noted earlier, however, not every social service intervention is amenable to a SIB-like arrangement, and equally, not every host govern-

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country, or combination of the two to remunerate investors); see also supra note 6.


The City of Fresno, California also is contemplating a SIB-like financing to tackle a healthcare problem—chronic asthma. See Manuela Badawy, California City Seeks to Cut Asthma Rate via Bond Issue, Reuters (Oct. 19, 2012, 10:50 A.M.), http://www.reuters.com/article/2012/10/19/us-investing-impactbonds-health-idUSBRE8910U120121019. Twenty percent of Fresno's population suffers from chronic asthma, while only eight percent suffer nationally. Id. If this transaction moves forward, it will be the first municipality in the United States to use a SIB-like funding structure. Id. In this pilot, however, the SIB payor is expected to be a not-for-profit organization, not the City of Fresno. Id.
ment is ready for such an arrangement. On the other hand, the development agency that is acting as the payor in a SIB structure could find itself subjected to second-guessing and political attacks regarding the amount of “success fees” it has paid to its SIB investors. It does not take an overactive imagination to picture a U.S. news organization or a member of Congress, for example, lambasting USAID for paying a tidy profit to a SIB investor like Goldman Sachs.80

The second downside, perhaps more troubling, is that this approach does little to change the attitudes or performance of the host government since it has been removed from the transaction. This lost opportunity could mean that, while individual SIBs may succeed under this variation, host governments will continue to provide social services to their populations (or not) with little regard to the actual outcomes of such services. The counter-argument might be that a development agency-sponsored SIB could provide an important demonstration effect to host governments that would eventually spur the host government to engage in similar SIB initiatives.

Third is the chance that, while some private investors will be disinclined to enter into any financial arrangements where they are obligated to pay for a development agency’s mistake (i.e., a poorly conceived or executed SIB), other investors may be concerned that they are not generating sufficient impact with this kind of donor government-sponsored SIB investment. This latter group may worry that they are merely displacing public sector capital with their own private sector capital. For these more “impact” oriented investors, it is likely that they will need to be convinced that 1) the SIB being presented to them by a donor agency is spurring a greater financial commitment by the development agency to the particular development goal being addressed by the SIB than otherwise would take place, or 2) the demonstration value to the host government of the SIB is so high that the host government itself will begin to assume more responsibility in future SIB transactions.

B. SIBs with Credit Enhancements

A second SIB variation embeds a credit enhancement or other type of risk mitigation instrument into the SIB structure

80. See discussion supra note 63 and accompanying text.
so as to lower the financial risk to SIB investors and, thereby, the ultimate cost of the SIB to the host government. This enhancement could take many forms, ranging from political risk insurance to third party guarantees. The following discussion looks at two very different types of credit enhancements that have been used, or are now available to be used, to reduce the risks and thus lower the costs of development-oriented projects. It also explores whether similar credit enhancements might be applied to SIB structures that involve a cross-border financing where many of the SIB investors sit far from the country where the SIB social services are being delivered.

1. Political Risk Insurance: Non-Honoring of Sovereign Financial Obligations

One product that could evolve to become a useful credit enhancement for SIB obligations is a new political risk insurance product issued by the Multilateral Investment Guarantee Agency ("MIGA"), a member of the World Bank Group. The product, called Non-Honoring of Sovereign Financial Obligations ("NHSFO"), takes advantage of recent changes in MIGA’s convention, and provides political risk insurance to transactions involving the financial obligations of sovereigns and sub-sovereigns. The NHSFO as currently designed sup-


Other types of political risk insurance could also be helpful to SIB investors in connection with a cross-border SIB investment. For example, SIB investors may consider currency inconvertibility coverage or political violence coverage. For a description of political risk insurance, including various types, see Political Risk Insurance, Overseas Private Investment Corporation—What We Offer, www.opic.gov/what-we-offer/political-risk-insurance (last visited Apr. 14, 2013).
ports projects that "involve either a direct payment obligation of the government, or a government guarantee of the obligations of a state-owned enterprise or public-private partnership joint venture."\textsuperscript{82} Essentially, the NHSFO insures lenders against losses resulting from the failure of a government (sovereign or sub-sovereign) to make a payment when due because of the government's inability or unwillingness to pay,\textsuperscript{83} but "only if the financial payment obligation of the sovereign is unconditional and not subject to any defenses—meaning that there are no grounds on which the sovereign could defend legally against the fact that the obligation is due."\textsuperscript{84} Given the uncertainty that surrounds the ultimate timing and amount of SIB payments to be made to SIB investors, NHSO coverage as currently defined may not fit well into a SIB structure. Creative SIB innovators, however, may be able to develop SIB arrangements that meet, at least in part, this unconditional payment obligation so that the SIB payments are an insurable risk.\textsuperscript{85} Or NHSO coverage could be expanded beyond its current scope. In either case, if it is possible to structure all or part of the host government's payments to SIB investors so that a SIB payment

\begin{itemize}
  \item \textsuperscript{83} See id.
  \item \textsuperscript{84} Id.; see also MIGA, \textit{Contract of Guarantee for Non-Shareholder Loans, Non-Honoring of a Sovereign Financial Obligation} art. 3 (Dec. 2012), http://www.miga.org/documents/disclosure/Contract%20of%20Guarantee%20for%20Non-Shareholder%20Loans-NHSO.pdf. Under the sample MIGA NHSFO contract, "Sovereign Financial Obligation" means: an unconditional financial obligation of the Governing Authority to pay a sum certain, either on a date certain or on demand, which obligation is either:
    \begin{itemize}
      \item in favor of the Guarantee Holder; or
      \item in favor of the Project Enterprise (whose rights against the Governing Authority have been collaterally assigned to the Guarantee Holder),
    \end{itemize}
    \textit{and which is not subject to any defenses other than payment, and may include without limitation an unconditional guarantee of a third party's financial obligations or an obligation to invest or contribute funds, either on a date certain or on demand} . . .

  \textit{Id.} at art. 2 (emphasis added).
  \item \textsuperscript{85} One possible avenue to explore is to determine whether a demand notice served on a host government for SIB principal payments (as opposed to the less easily quantified sliding success fees) under a SIB contract might qualify as an insurable risk under NHSFO contracts.
\end{itemize}
obligation would be covered by NHSO insurance, then this new political risk insurance product could become a powerful tool for taking SIBs global, particularly to markets where host government counterparty risk is high.\textsuperscript{86}

2. \textit{Rolling Credit Guarantees}

As noted previously, the New York City SIB enjoys a rolling guarantee from Bloomberg Philanthropies.\textsuperscript{87} To summarize, this guarantee fund is held by the MDRC. Should any funds remain in the guarantee fund after this first SIB is paid out, the MDRC can use those remaining guarantee funds to support another SIB.

Although this rolling guarantee fund reduces investor risk, it presents two challenges. First, it will take several years before MDRC will be able to determine whether it needs the full amount of the Bloomberg guarantee to make payouts to Goldman Sachs. This could delay the launch of other valuable SIB structures. Second, it presumes that the MDRC will continue to be the most appropriate intermediary for those next SIB structures.

A large rolling guarantee fund that is not dependent on just one SIB intermediary and that supports multiple SIBs, simultaneously pooling SIB risk across several transactions, could hold even greater promise for the SIB ecosystem. To that end, some lessons might be learned from another development-oriented, rolling guarantee fund—the Grameen Growth Guarantees program.

Launched in 2005 by the Grameen Foundation ("Grameen"), the Grameen Growth Guarantees program is "one of the microfinance industry's largest financing efforts dedicated to ensuring local currency financing for rapidly

\textsuperscript{86} Another reason that qualifying for NHSFO insurance could be a powerful tool for expanding the SIBs globally is that this insurance product was designed to be Basel II compliant. This means that commercial banks benefitting from NHSFO coverage may receive capital relief, which in turn could allow them to continue lending into MIGA member countries. See MIGA NHSFO Brief, \textit{supra} note 82, at 1. Accordingly, this new insurance product might be able to help SIB structures also attract commercial bank lenders as SIB investors.

\textsuperscript{87} GODIKE \& RESNER, \textit{supra} note 29, at 22.
growing microfinance institutions."88 The program relies on a pool of $60 million being made available by donor-guarantors who "provide their names and credit while continuing to earn returns on their individual investment portfolios."89 This donor/guarantor pool is used as collateral to support standby letters of credit issued by a money center bank to local banks, which in turn make loans to microfinance institutions that are located in the banks’ respective countries of operation.90 Since the inception of the Grameen Growth Guarantee program, it has raised more than $200 million in local-currency funding for 24 microfinance institutions.91

There are several aspects of the Grameen Growth Guarantee program that could inform the structure of a SIB rolling guarantee fund. Perhaps the most important question to ask when considering a third party guarantee is who should be the guarantor(s)? Grameen has largely looked to high net worth individuals to act as its donor/guarantors. As the Grameen Growth Guarantee program demonstrates, this is a highly successful funding strategy for guarantee pools of $60 million. Less clear is whether high net worth individuals will support much larger guarantee pools.

One alternative to finding high net worth individuals willing to act as guarantors is to look to a donor country (or countries) to be the source of the credit enhancement. The International Finance Facility for Immunisation (IFFIm) provides a


89. Id. There are two interesting U.S. tax consequences for donor/guarantors related to this structure. First, during the time that the donor/guarantor funds are held as collateral for the issuer of the standby letters of credit donor/guarantors will be subject to tax on the earnings and gains that they realize on such assets. If there is a draw on this collateral that results in all or some of the donor/guarantor’s pooled assets being transferred to satisfy Grameen’s obligations under this program, however, the donor/guarantor should be entitled to a charitable contribution deduction at the time that it passes those assets to the Grameen Foundation in the form of a grant. The value of this deduction will be equal to the value of the assets transferred (provided that those assets consist of cash and qualifying long term capital gain assets that are not subject to reduction under Section 170(c) of the Internal Revenue Code).

90. What We Do, supra note 88.

91. Id.
striking example of a large fund supported by pledges from many sovereign donors. Since its inception in 2006, the IFFIm has generated new private investment for immunization programs carried out by the GAVI Alliance.92 IFFIm uses long-term pledges (up to twenty years) from Australia, United Kingdom, France, Italy, Norway, Spain, the Netherlands, Sweden, and South Africa to support payments on "vaccine bonds" that it then sells to private investors that want a market-based financial return and development impact.93 As of July 2012, IFFIm had raised $3.7 billion from investors, of which $2 billion has been used to fund the purchase and delivery of vaccines.94

Yet, as IFFIm currently is experiencing, the value of a sovereign credit enhancement is only as good as the creditworthiness and commitment of its sovereign donor/pledgor. As of December 2012, all three of the major rating agencies (Moody’s, Standard & Poor’s, and Fitch) had a negative outlook on the high ratings they assigned to IFFIm bonds.95 It


93. Under the IFFIm structure, sovereign donors enter into a pledge agreement with the GAVI Alliance that specifies their overall pledge amounts and payment schedules for providing such pledged amounts. Over time GAVI grants (it does not lend) to IFFIm the donors’ pledged amounts. IFFIm uses this right to future cash flows to access the international debt markets by issuing notes to private investors. The pledged amounts granted to IFFIm are then used for debt service on the notes and operating expenses. See ANNETTE SWAHLA, Moody’s Investors Service, CREDIT ANALYSIS: INTERNATIONAL FINANCE FACILITY FOR IMMUNISATION 2 (Dec. 20, 2012), available at http://www.iffim.org/library/documents/ratings-reports/ (last visited Apr. 14, 2013).


95. See Announcement, Moody’s Investors Services, Moody’s Changes Outlook on Aaa Rating of IFFIm to Negative; Ratings Affirmed” (Dec. 14, 2012), http://www.moodys.com/page/viewresearchdoc.aspx?docid=PR_262294&WT.mc_id=NL.TITLE_YYYYMMDD.PR_262294. Moody’s notes that its negative outlook on the rating is reflects not only recent downgrades of donors to IFFIm but also the “low-probability but high-impact event whereby a significant portion of the donor payments, on which IFFIm is reliant, could face disruption owing to the high correlation of donors’ credit standings.”
should be noted, however, that the development purpose of the IFFIm bonds appears to reinforce the perceived commitment of the sovereign donors in the eyes of the rating agencies. Moody’s, for example, has noted that not only are the donor countries financially able and legally bound to meet their IFFIm commitments but the donor countries also share a strong commitment to make good on their pledges given the developmental purpose to which the pledged funds are being put.96

Thus, IFFIm bonds offer a cautionary, yet optimistic, lesson for SIB structures that might seek credit enhancements in the form of long-term pledges or guarantees from sovereign donors—namely, sovereign risk can be found in the contractual obligations of developed as well as developing countries. Accordingly, SIB investors that act in reliance on the performance of such sovereign donor pledges or guarantees should make sure that the sovereign donors have the long-term financial ability and political will to honor their commitments.

A second structural issue to consider when developing a rolling guarantee is to determine the amount of leverage that the guarantee is intended to generate. Or, to put it in the SIB context, how much risk exposure should SIB guarantors cover and how much risk should SIB investors assume? The Grameen Growth Guarantee program very successfully leveraged its donor/guarantors funds so that for each $1 of donor/guarantor support in the form of a standby letter of credit it has attracted around $4 in local bank funding to microfinance

SWAHILA, supra note 93, at 1, 4 (explaining that France is IFFIm’s second-largest donor; France, Spain, and Italy’s original total pledges to IFFIm comprise 41.4% of the total pledges over IFFIm’s full life). See also STANDARD & POOR’S RATING SERVICES, RESEARCH UPDATE: INTERNATIONAL FINANCE FACILITY FOR IMMUNISATION “AA+/A-1+” RATINGs AFFIRMED; OUTLOOK REMAINS NEGATIVE (December 17, 2012) (stating that outlook remains negative, reflecting negative outlooks on IFFIm donor sovereigns); Press Release, Fitch Ratings, Fitch Affirms International Finance Facility for Immunisation at “AAA”; Outlook Negative (Dec. 14, 2012) [hereinafter Fitch Press Release].

96. SWAHILA, supra note 93, at 1 (stating that donors’ continued strong ability to make scheduled payments is reinforced by “very strong” donor willingness to honor pledges based on IFFIm’s developmental purpose); see also Fitch Press Release, supra note 95 (explaining that strong donor support is due to high overall credit quality, legally binding nature of pledge commitments, and “severe reputational damage” to any repudiating donor).
institutions. Are there potential guarantors that would also be more likely to join a SIB transaction if they saw their guarantors catalyzing similar amounts of funding?

A final structural issue is to determine the appropriate length of time for a SIB rolling guarantee fund to "roll." Which interests should inform that decision—those of host governments wishing to participate in SIBs, potential SIB investors, or those who are being tapped to be SIB guarantors? The short answer is that all of these interests should be considered. The longer answer is that SIB guarantors that agree to participate in a rolling guarantee generally would need to have a significantly longer investment horizon than the SIB investors in any single SIB transaction or there will be little room for any guarantee to roll. A rolling guarantee could be structured, however, so as to permit individual guarantors to exit at their own option, provided that the exiting guarantors make good on any and all SIB guaranteed obligations that were incurred during the time of their guarantee.

While the foregoing is not an exhaustive list of questions that would-be architects of a SIB rolling guarantee fund should consider, it is perhaps a start.

C. Variation on SIBs

One particularly thorny issue that challenges those who are intent on taking SIBs or SIB-like structures to emerging markets is the long period during which SIB investors' capital may be put at risk. Because of the relatively long duration of SIB contractual arrangements and the (related) limited liquidity of SIB investments themselves, nearly every SIB investor today is likely to be a "buy and hold" long-term investor. Unless

97. What We Do, supra note 88.

98. In addition to these structural issues, there also are important operational issues to consider. Grameen, for example, created eligibility criteria and due diligence processes to ensure that it chose wisely when selecting microfinance institutions that would benefit from this Growth Guarantee program. See Grameen Foundation Growth Guarantees, http://www.grameencapital.in/images/growth_guarantees.pdf.

99. There are structural ways to try to tighten these long investment horizons of SIBs, such as tranching over time the SIB investors' disbursements. The challenge, however, is balancing the timing of tranched disbursements against social service providers' need to obtain upfront funding to run their operations.
they are philanthropically motivated, investors who are willing
to take a chance on such a long-term, illiquid investment in an
emerging market context are likely to do so only at a steep
price. This high cost of capital itself can make a SIB transac-
tion impractical. Accordingly, the following discussion focuses
on finding a way to shorten the period during which private
investors' capital is at risk, while still finding a source of up-
front funding that can be provided to social service providers.

1. Performance-Based Debt Buy-Downs

One already-existing social finance innovation that seems
particularly amenable to being supported by a SIB-like struc-
ture (and vice versa) is the World Bank and International De-
velopment Agency (“IDA”) performance-based debt buy-down
mechanism. The World Bank Group started piloting perform-
ance-based debt buy-downs in polio eradication projects for
Pakistan and Nigeria that were approved by the World Bank
Board between 2003 and 2005. Just as SIBs can expand the
reach and accountability of pay-for-success government con-
tracts, integrating SIBs into the performance-based debt buy-
down agreements being arranged by the World Bank and IDA
in their respective countries of operation also could expand
the reach and accountability of those agreements.

This is how the debt buy-down works in concept. First, the
IDA or the World Bank issues a loan to a host government, the
proceeds of which are to be used to pay for services that are
likely to achieve specific performance outcomes. Then, if
the agreed performance outcomes are achieved, grant money
from philanthropists and development assistance organiza-

100. See World Bank, Healthy Development: The World Bank Strategy
for Health, Nutrition & Population Results 56 (2007) [hereinafter
World Bank HNP Strategy], http://siteresources.worldbank.org/
HEALTHNUTRITIONANDPOPULATION/Resources/281627-1154048816
360/HNPStrategyFINALApril302007.pdf (first projects took place in Paki-
stan and Nigeria). Many of the World Bank/IDA projects benefiting from
the performance-based debt buy-down mechanism are health-related. In
part, this financial innovation was born out of the growing awareness that
good governance and accountability are critical determinants of health sys-
tem performance. Id. at 28. Also, as the World Bank has acknowledged, it is
handicapped by the fact that the World Bank is required to affect health
outcomes only indirectly by “using its lending and nonlending services to
influence domestic actors, particularly governments.” Id. at 55.
101. Id. at 56.
tions "buys down" this loan (in all or in part).\textsuperscript{102} If the agreed performance outcomes are not achieved, then the loan remains a debt obligation to be serviced by the host government and repaid to IDA or the World Bank.\textsuperscript{103}

The types of IDA or World Bank projects that are eligible for a debt buy-down must include all of the following features:

- **Significant cross-border externalities.** The primary selection criterion is that eligible projects or project components must have significant positive cross-border externalities linked to the achievement of the [Millennium Development Goals].

- **Measurable outcomes.** Projects or components must have measurable and feasible outcomes that can be achieved through policy actions by the government so that the trigger-point for buying down the credit will be transparent and objective. Countries must also have adequate monitoring systems to measure these outcomes.

- **Standard Bank appraisal requirements.** Projects must meet appraisal requirements and standards applied to all projects. In particular, investment in a project using a credit buy-down must be supported by a strong political commitment by the government and be used for activities that are cost-effective, fiscally sound, and equity enhancing.\textsuperscript{104}

Since the initial Pakistan polio eradication pilot that was approved by the World Bank’s Board of Directors in 2003, the World Bank has approved additional financing for two further debt buy-down projects in Pakistan. Most recently, in April 2011, the World Bank Board of Directors approved $41 million for the “Third Partnership for Polio Eradication Project,” which provides financial resources to the Pakistan government to procure the Oral Polio Vaccine as part of the Pakistan government’s efforts to immunize 32 million children against polio with the ultimate goal of eradicating polio from the coun-

\textsuperscript{102} Id.
\textsuperscript{103} Id.
\textsuperscript{104} Id.
These Pakistan transactions were supported by grant funds provided by the Bill & Melinda Gates Foundation and Rotary International (through the United Nations Fund) to an IDA-administered fund called the Polio Eradication Trust Funds ("PETFs"). PETFs is charged with buying down IDA debt incurred by recipient countries for successful implementation of polio eradication projects. PETFs will pay all applicable service charges and commitment charges, if any, on the IDA debt extended to Pakistan for this purpose; and, most pertinent to this discussion, PETFs will buy down the net present value of this IDA debt obligation upon successful completion of the project, as determined by a performance audit conducted by an independent agency competitively selected by the World Bank.

Another recent example of a performance-based debt buy-down mechanism is a project in Botswana that aims to contribute to the increased efficiency of Botswana's national HIV/AIDS program. This was the first time the buy-down mechanism was used for a debt buy-down project.


107. Id.

mechanism was used in Africa. Because the World Bank categorizes Botswana as an upper middle income country, which makes it ineligible for an IDA credit, the buy-down is linked to a World Bank loan.\footnote{109} Another difference is that the Botswana debt buy-down will be applied just to interest payments owed on this World Bank loan and not to the principal amount. The World Bank loan is $50 million and is supported by a grant contribution of approximately $20 million from the European Commission to be applied to a performance-based buy-down of the interest payments owed on this World Bank financing should the performance targets be reached.\footnote{110}

So, as with SIBs, these World Bank/IDA performance-based debt buy-downs: 1) establish measurable performance outcome objectives, 2) apply independent monitoring and assessment of the targeted performance outcomes, and 3) link the results of these performance outcomes to financial incentives for the host government (in this case, the conversion of an outstanding debt obligation of the host government into a grant if the targets are achieved, or the continuation of the outstanding debt obligation of the host government if the targets are missed).\footnote{111} There is also a fourth element to this

\footnote{109. This is the second buy-down of a World Bank loan (as opposed to an IDA credit). The first buy-down mechanism of a World Bank loan was to support tuberculosis control in China. \textit{Id} at 3.}

\footnote{110. \textit{See} World Bank, Press Release, \textit{supra} note 108. The targets for this World Bank loan are as follows:}

- Improved performance of the National Aids Coordinating Agency;
- Reduction in proportion of sexually active males and females who report having had sex with more than one partner in the past 12 months by age group;
- Increase in proportion of youths aged 15-to-19 years and 20-to-24 years who both correctly identify ways of preventing the sexual transmission of HIV and who reject major misconceptions about HIV transmission;
- Increase in proportion of youth aged 15-to-19 years and 20-to-24 years reporting either (a) no sexual activity or (b) condom use during the last sexual encounter with a non-regular partner in the past 12 months; and
- Reduction of proportion of people 15-to-19 years and 20-to-24 years who report a sexual partner with more than 10 years age difference during the last 12 months.

\textit{World Bank, Botswana, \textit{supra} note 108, at 2.}

\textit{111. World Bank HNP Strategy, \textit{supra} note 100, at 56.}
debt buy-down mechanism that some SIB structures now (and, in the future, increasingly may) avail themselves of: sizeable philanthropic capital that is keenly interested in seeing performance objectives realized.

On the other hand, there are several significant differences between the performance-based debt buy-down mechanism and SIBs. A first difference is that there are two possible sources of budgetary savings for the host government under the debt buy-down mechanism. As in SIB structures, it is possible that budgetary outlays will be reduced as a result of the improved performance outcomes resulting from a successful performance-based debt buy-down. The amount of these budgetary savings, however, will turn on the amount, if any, that the host government is otherwise spending on the problem that is being addressed by the debt buy-down. Additionally and perhaps more importantly, host governments will realize direct budgetary savings as a result of the debt reduction that is provided upon the achievement of performance outcomes. A second difference is that the upfront capital needed to scale the contracted social services is being provided by the World Bank/IDA rather than by private sector investors. A third difference is that there is no intermediary function being performed by a private sector entity in the debt buy-down mechanism. This leaves much more control and responsibility in the hands of the host government.

2. Integrating Private Sector Investors into Performance-Based Debt Buy-Downs

What role, if any, is there for a private sector investor in a SIB-like structure that is built on the backbone of a performance-based debt buy-down mechanism offered by international financial institutions like the World Bank and IDA? There are at least three reasons to include private investors in such buy-down arrangements. First, private investors can bring additional funds to augment the capital being provided by the World Bank/IDA to finance the social services being contracted. In turn, this reduces over time the amount of public sector funds needed to finance such social services. Second, by integrating private investors as co-financers, even if only in small part, into early-stage performance-based debt buy-downs, host governments have an opportunity to demonstrate their
capacity to deliver on pay-for-success contracts. Such a demonstration should mean that participating investors are more likely to co-invest in future buy-down schemes, and the size of success fees (or, to put it differently, the risk premium) needed to attract private investors would diminish over time.\textsuperscript{112} Third, private investors, particularly if they are local investors, may be able to exert additional market and political accountability over the host government involved in this financial public/private partnership.

Even with these advantages, there are significant costs that a structure like that described above could still incur—particularly, costs attributable to foreign exchange risks if any private investors are foreign and the funding is long term. It is also possible that some governments are avoiding participating in these performance-based debt buy-downs because they are concerned about incurring sizeable loans where their repayment obligations depend on the capacity of private sector actors—the social service providers—to perform. Put differently, for a host government, there is a strong incentive to avoid taking a risk on a performance-based debt buy-down because a failed performance-based debt buy-down leaves the government with a considerable debt obligation to IDA or the World Bank and no measurable improvement in the development goal that the buy-down was meant to address. So, another option is to introduce to the performance-based debt buy-down mechanism a financial instrument well known to anyone who

\textsuperscript{112} As discussed previously in Part IV, in SIB structures where the host government has a payment obligation that is linked to the successful completion of a performance target, there can be an inherent moral hazard risk. That is, the host government could be financially better off if the performance outcomes that otherwise would trigger a payment obligation by the government are “just missed.” This moral hazard is not present in the performance-based debt buy-down mechanism because the host government reaches a better financial outcome, that of debt reduction, if the performance outcomes are fully achieved. Accordingly, the prospect of some debt relief, perhaps even a sliding scale of debt relief that is tied to the degree of success, should reduce the likelihood of a host government interfering, intentionally or unintentionally, with the achievement of targeted outcomes and delivery of social services aimed at achieving those outcomes. Moreover, incorporating the World Bank Group when performance outcomes are being assessed reduces the risk that the host government would tamper with the data being evaluated.
engages in government construction contracts: performance guarantees (also called surety bonds).

3. **Social Impact Performance Guarantees ("SIP Guarantees")**

A performance guarantee typically involves three parties—the performance guarantor, the contractor/concessionaire, and the beneficiary of the guarantee (the contracting government authority). Under a performance guarantee, in the case of a performance failure, the performance guarantor can choose to 1) rectify the problem itself, 2) obtain another contractor to rectify the problem and compensate the contracting authority for losses caused by the failure to perform, or 3) discharge its guarantee obligations solely by payment of money to the contracting authority. In short, the performance guarantor performs many of the management functions that the SIB structure now delegates to the SIB intermediary, such as monitoring and providing general oversight with respect to the SIB's overall performance.

Performance guarantors themselves, however, must demonstrate their financial ability to compensate the contracting authority in the event of contractor default. This is where private investors could be integrated into the existing performance-based debt buy-down structure. Namely, SIB investors could provide guarantees (possibly in the form of collateralized standby letters of credit issued to local banks in the host country) or other forms of financial support (possibly even making equity investments in the entity that is to act as the performance guarantor) to backstop the financial obligations of the performance guarantor. By eliminating the need for long-term funding to be provided in-country by the private investors, the foreign exchange risk of engaging in a multi-year SIB would be diminished (thereby also reducing costs of a SIB

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113. In a surety bond, the parties would include a surety agency as the guarantor, the project owner as the obligee, and the contractor as the principal. See About Surety, THE SURETY & FIDELITY ASSOC. OF AM., http://www.surety.org/?page=AboutSurety (last visited Apr. 14, 2013); see also Edward G. Gallagher & Mark H. McCallum, The Importance of Surety Bond Verification, 39 PUB. CONT. L.J. 269, 269-70 (2010).

arrangement). Additionally, this structure, which puts its investors on the hook only for future contingent obligations, might make it easier for these same investors to create a SIP Guarantee that could be used to support multiple debt buy-down arrangements, thereby also pooling risks across transactions and perhaps even countries while minimizing transaction costs of setting up a new performance guarantee vehicle for each debt buy-down.

In a SIP Guarantee that is applied to a debt buy-down the upfront capital needed to fund the social service providers would continue to be provided through the proceeds of loans extended by the World Bank or IDA to the host government. Like a SIB structure, however, the performance guarantor (backed by private investor/guarantors) would guarantee the achievement of the targeted performance outcomes, thereby shouldering the execution risk of the social service providers. Exhibit B illustrates the basic structure of a SIP Guarantee.

The SIP Guarantee needs at least two features to address the allocation of risk and return. First, to attract a private investor/guarantor, a SIP Guarantee needs a sliding guarantee fee that correlates positively to the successful achievement of performance outcomes just as the financial returns paid on the early SIB investments operate with a sliding scale of success fees. Second, to deter the host government from interfering, directly or indirectly, with the achievement of targeted performance outcomes, SIP Guarantees should contain an express government interference “carve-out” from the guarantee such that the private investor/guarantor could refuse to pay.

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115. There still would be some foreign exchange risk related to the transfer risk of moving guarantee fees from the host country to the foreign investor, but there would not be any significant devaluation or depreciation risks.

116. See Exhibit B for the respective functions and roles of the actors in a SIP Guarantee. Steps 1–4 outline in general terms the existing loan disbursement process for an IDA/IBRD performance-based debt buy-down structure. Steps 5–6 outline how funding flows if the performance targets are met. Namely, the host government is relieved of its debt obligation to IDA/IBRD, and the SIP Guarantors receive guarantee fees that are correlated to the successful performance outcomes. Steps 7–8 illustrate what happens if the performance targets are not met. In this worst-case scenario, the SIP Guarantors make a guarantee payment, provided that inappropriate interference by the host government was not the cause of the missed target. This guarantee payment then is used by the host government to repay the IDA/IBRD loan obligation.
on the performance guarantee if the host government's actions (or inactions) are shown to be the proximate cause of the failed performance outcomes.

How would this SIP Guarantee work if the targeted performance outcomes were not met? As a general rule, if targeted performance outcomes were not met, the private investor/guarantor would be called upon to pay on the performance guarantee, which would be in an amount equal to the upfront cash funding provided by the host government to those social service providers. The IDA or World Bank loan would remain outstanding unless the host government was to use the guarantee payment to reduce some or all of the debt obligation.\(^\text{117}\) If the failure to achieve the targeted performance outcomes is due to the host government's political interference, however, then the private investor/guarantors would have no obligation to pay the host government, and the World Bank/IDA loan would remain outstanding.

On the other hand, if the performance outcomes are achieved, then 1) the SIB investor/guarantors would receive a sliding "guarantee success fee" in addition to their annual guarantee fee from the host government, and 2) the World Bank/IDA would buy down, using philanthropic funds, all or

\(^{117}\) It is likely that in this scenario the World Bank or IDA would require all performance guarantee payments to be assigned directly to it in satisfaction of the outstanding debt obligation owed by the host government.
part of the host government's outstanding performance-based debt obligation.118

In sum, if structured appropriately, by integrating a SIP Guarantee into performance-based debt buy-downs, the risks of this financial partnership can be realigned so that private sector investors (the private investors/guarantors) assume the performance risk of the key private actors (in this case, the social service providers), public investors/lenders (like the World Bank and IDA) assume the performance and financial risk of the key public actors (in this case, the host government), and philanthropists pay only for those projects that demonstrably achieve their targeted outcomes.

V. CONCLUSION

The excitement generated by SIBs may not be fully deserved at this time given the very limited track record of this social finance innovation. Yet there is much about these early SIB structures that deserves careful attention and consideration. Like the best of public/private partnerships, SIBs can help mobilize private sources of capital to promote the efficient targeting and expansion of government-contracted social services. Moreover, given current financial constraints on host governments and donor assistance organizations, SIBs offer an opportunity to attract private sector investors to help fund solutions to some of the world's most pressing problems. But taking SIBs to the countries where they could be most useful will not be easy, particularly if those countries suffer from weak governance structures and leadership. Accordingly, new SIB structures and new SIB actors will need to be introduced. Creative arrangements for sharing SIB risks and returns will need to be negotiated. Thoughtful assessments of costs and benefits of proceeding with SIB or SIB-like structures will need to be undertaken. Of equal importance, thought should be given to how these SIB variations are sequenced in a given country so

118. Presumably the guarantee fees payable by the host government would be much less, even after taking into account guarantee success fees, than the outstanding debt obligation to be retired by IDA and the World Bank as part of the debt buy-down. This debt relief then should free up additional resources that can be used by the host government to make its SIB guarantee payments.
that host governments are able, over time, to build a track record of success that demonstrates their capacity and willingness to be a successful SIB partner.