A QUESTION OF DEVELOPMENT

39 SEPTEMBER 2018

SYNTHESES OF AFD STUDIES AND RESEARCH

How should we evaluate the financial risk associated with *Social Impact Bonds*?

PROPOSALS FOR AN ANALYTICAL METHOD

Successful prevention programmes focusing on key social issues (health, education, reoffending rates, rehabilitation, etc.) can help the public sector to reduce future costs (hospital care, special schools, prisons, etc.) by more than the cost of the preventive actions. Nevertheless, the results of such initiatives are unpredictable, and as such they represent risky investments for the public sector. This means that potentially useful schemes are often abandoned for budgetary reasons.

The aim of the SIB is to encourage the private sector to take on some of the risk associated with prevention programmes, by establishing a contract which sets out, on the one hand, the sums required from private investors to fund social-interest programmes, and, on the other, the quantified objectives of these programmes, thresholds above which the public sector will begin repaying the investors' capital with interest.

The Social Impact Bond (SIB) is a new financial product designed to attract private investment in public interest projects of a social nature, and specifically in prevention programmes.

History of Social Impact Bonds

The first SIB was launched in the United Kingdom in 2010. The pilot programme was a scheme to cut reoffending rates among inmates serving short sentences at HM Prison Peterborough. Upon release, offenders were provided with personalised follow-up care and support from various associations, helping them to find housing, employment and, where necessary, treatment for drug and alcohol dependency. The programme was scheduled to cost a total of 5 million GBP, with the aim of reaching 3,000 people and cutting the reoffending rate by 7.5%. The scheme was funded by private investors, primarily for charitable reasons. These investors were to be reimbursed by the UK Ministry of Justice and the Big Lottery Fund. The programme ultimately achieved a 9% reduction in the reoffending rate, thus surpassing its initial target.

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Building on this pilot scheme, as of March 2018 over 100 SIBs had been launched, primarily in the UK (40) and the USA (20), but also in the Netherlands (8), Australia (8), India (2) and Peru (1), with a combined budget of over $400 million (USD). According to a September 2017 report published by the think tank Brookings, around 25 SIB projects are currently in the planning phase in emerging and developing economies.

While the sums involved remain modest in the context of the financial markets, SIBs (originally funded by charities or social investment agencies) are now beginning to attract interest from the traditional banking sector. In France, a call for proposals was organised by the Ministry for the Economy and Finance between 16th March 2016 and 30th January 2017, with the aim of encouraging the development of this new financial tool. By the end of March 2017 around sixty proposals had been submitted. Several French banks and financial institutions expressed an interest in SIBs, including BNP Paribas, Caisse d'Epargne, the Caisse des Dépôts et Consignations (CDC), Crédit Coopératif and the Agence française de développement (French Development Agency, AFD).

A new type of financial risk...

Thus far, the development of the SIB sector has been highly variegated in terms of the investments made and their legal and financial structuring. SIBs are constructed on a case-by-case basis. Their legal and financial structuring is often the fruit of a compromise between the various stakeholders over the projects' timescale and targets, the applicable legal framework and the nature of the investors and third-party backers. Contractually speaking, these investments may take the form of loans, bonds or even equity investments.

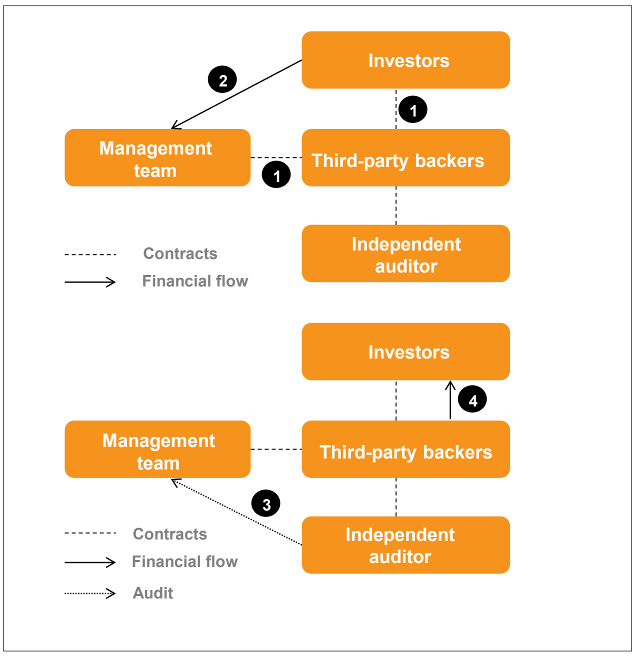
However, regardless of their structuring, the nature of the financial risk associated with SIBs is tricky for financial institutions to fully comprehend, since analysing their level of credit risk is primarily a matter of assessing the operational capacity of a third party to deliver a specific result, rather than the counterparty's ability to pay.

And yet, accurate assessment by banks of the financial risk associated with SIBs will be indispensable if this instrument is to continue to develop, helping not only to guide investment decisions but also to shore up accounting and regulatory management practices. Constructing robust, homogeneous evaluation techniques could be a catalyst for the growth of this market, and help SIBs to attract investors on a new scale.

...which requires us to update our financial evaluation techniques.

We propose a new evaluation methodology focusing on five essential criteria: the quality of the contractual arrangements and governance of the programme; the robustness of the programme's design and the assessment of its results; the quality and viability of the programme's management team and associates; assessment of the programme's chances of success and analysis of its financial structuring; and, finally, counterparty risk.

FIGURE 1. OPERATING PRINCIPLE OF A SOCIAL IMPACT BOND



AT THE PROGRAMME'S START

1 - Investors sign a loan agreement with third-party backers, who commit to paying the principal plus interest to the investors in function of whether the programme goals have been reached.

1 - Simultaneously, the third-party backers sign a project supervision contract with the operator.

2 - The investors transfer the funds directly to the programme management team.

AT THE PROGRAMME'S END

3 - The independent auditor evaluates the results reached in the scope of the programme.

4 - If the objectives are met, the third-party backers repay the principal plus interest to the investors.

Source : Author.

SIBs are based on an original contractual arrangement whereby the reimbursement of investors is index-linked to precise and quantifiable targets. The coordinator of the programme will be responsible for meeting these targets. The aim here is to limit the scope for interpretation, and thus for potential differences of opinion with the payer, and also to provide the programme coordinator with a clear line to follow. SIBs generally focus on a specific geographical area, creating ample opportunities for conflicts of interest, in particular when an operator is involved in both prevention and treatment of a given issue (for instance an organization that manages dialysis centers and would seek to participate in a diabetes prevention program). Analysts will thus be required to assess the risk of conflicts of interest arising between the stakeholders, and the extent to which they are effectively handled in the contractual arrangements (for example, with a clause requiring investors to vote on all decisions deemed to be at risk of a conflict of interest). SIBs are long-term projects, generally running for between 3 and 8 years. This timescale is longer than periods commonly seen in social prevention programmes operated by private service providers (associations, companies, etc.). Service providers thus need not only to have an incentive to continuously optimise the impact of their actions, but also to be able to alter the programme's strategy and structure, if need be, to attain or even surpass the initial objectives.

Compatibility of prevention programmes with the context and beneficiaries is an essential factor in determining an SIB's chances of success. There are three key criteria to take into consideration here.

• **Compatibility with the local context:** the programmes funded by SIBs aim to prevent the emergence or deterioration of social and/or physical problems, generally caused by environmental factors. These local/social problems need to be taken into account when constructing the project methodology, in order to effectively combat or reduce their incidence. This compatibility between methods and objectives will be a determining factor in the SIB's success.

• **Compatibility with beneficiaries:** maintaining the commitment and motivation of beneficiaries is one of the keys to the success of any SIB. But these programmes are generally designed to reach potentially fragile groups, who are suffering or at risk from social and/or health-related problems. As such, if the programme fails to deliver concrete short-term benefits for the participants, there is a greater risk of disengagement, as beneficiaries may be more inclined to prioritise the problems which affect them more directly on a day-to-day basis. Analysts must therefore assess how effective the methodologies used are in delivering: (i) a clear explanation of the effort and commitment expected of beneficiaries before the programme begins; (ii) mechanisms for motivating beneficiaries throughout the programme (incentives, seminars, etc.) and (iii) the delivery of concrete benefits clearly perceptible in the short term, even if not entirely correlated with the programme's ultimate goals.

• **Quality of the performance indicators used:** The quality of the indicators used to assess a programme's social impact is a key factor in the analysis of SIBs, allowing service providers-coordinators to accurately track the effects of their programmes and make any necessary changes, while also facilitating the process of paying out performance-indexed payments to investors.

SIBs generally bring together organisations with different skills and capacities. The success of any programme depends on the ability of these organisations to fulfil and coordinate their respective missions. The quality of the service provider-coordinator and sub-contracted service providers is one of the most important factors when analysing the potential of an SIB. There are three major points to take into consideration:

• **Quality and suitability of human resources:** The scale of the programme and the methodology employed will determine the exact number of staff required.

• **Assessing the track record of service providers:** In order to assess the level of experience of the various service providers, the analysis should incorporate an evaluation of the track record of each of the organisations involved in deploying the prevention programme. If the service providers do not have a sufficiently extensive track record in their current form, analysts may choose to look instead at the track record of their key personnel.

• **Viability of the management team and service providers:** The programmes funded by SIBs generally reach maturity after more than 3 years. It is therefore crucial to assess the financial viability of the service provider-coordinator.

The fourth key factor to take into account is the programme's chances of success and level of credit risk, considered independently of the aforementioned qualitative factors. Particular attention should be devoted to analysing the different levels of targets set in comparison with the results attained by similar programmes, and the quality of the guarantees offered by this SIB. Analysts must thus identify programmes which have focused on similar problems and check the results they have attained. This analysis should not be restricted to prevention programmes operated by SIBs, but should be expanded to include studies and programmes funded through more traditional channels. The aim is to create a comparison group which is relevant to the SIB in question. Once the comparison group has been established, analysts can compare the results obtained by these programmes with the targets set for the SIB in question, and thus estimate the programme's chances of succeeding. If the targets set out in the contract have never been achieved by any comparable programme, the chances of success must be deemed low. On the other hand, if the SIB has set itself objectives already attained by a number of similar programmes, it has a high chance of succeeding. A qualitative capacity ratio may be used in order to estimate the probability that a given programme will successfully achieve its targets, and thus reimburse its investors.

Analysing the financial structuring provides further useful information when it comes to evaluating the financial risk associated with SIBs. The presence of a sliding scale for targets is particularly important. Establishing a system of intermediate targets which trigger staggered repayment of the principal (with interest) reduces the risks of SIBs for investors, because even if its overall chances of success are high, an SIB with no sliding scale of targets still presents a considerable risk that all the principal invested will be lost. Different types of intermediate targets may be set, based on operational objectives (x number of beneficiaries, x hours of awareness training conducted, etc.) or the attainment of partial impact results (x% reduction in reoffending rates, etc.). The presence of subordinated debt tranches or guarantees is also a key factor helping to reduce the level of risk borne by investors.

Finally, analysts must assess the repayment capacity of the counterparty, in this case the third-party payer behind the prevention programme. With SIBs, the third-party payer is generally a government agency or some other public sector entity (local authority, national agency, parastatal company, etc.) that already benefits from a rating by the three major rating agencies. This can help to simplify the analysis.

The purpose of rating systems is to provide decision-making tools for financial institutions, particularly in terms of the return on investment on offer. The greater the risk, the closer this ROI will need to be to that seen on standard equity investments. Conversely, the better the rating, the closer the risk-return ratio will be to that of a standard loan agreement. Evaluating the financial risk associated with SIBs is also a major priority for investment banks, which are increasingly taking an interest in this instrument in the slightly adapted form of *Development Impact Bonds* (DIB).

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Publication director: Rémy RIOUX · **Editorial director**: Thomas MELONIO · **Agence Française de Développement**: 5, rue Roland Barthes - 75598 Paris Cedex 12 ·
Legal deposit:Decembrer 2018· **ISSN**: 2271-7404 · **Conception**: NOISE **Layout**: Eric THAUVIN . **Translation**: Bruce KELLEY

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