SOCIAL FINANCE Mobilizing Investment Capital to Drive Social Progress

Foundations for Social Impact Bonds

How and Why Philanthropy Is Catalyzing the Development of a New Market

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Acknowledgements

This report reflects the contributions of many people.

First and foremost, we would like to thank all of the individuals who took the time to share their perspectives on this new market with us. Their thoughtful observations provided significant insight into how philanthropy perceives this space.

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Any errors or omissions are ours alone.

This paper was written by Jane Hughes and Jill Scherer.

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Foreword

Rockefeller Foundation
Innovation for the Next 100 Years

For the past century, The Rockefeller Foundation's mission to promote the well-being of humanity has been marked by a strong commitment to both innovation and collaboration to solve some of the world's most pressing challenges, whether it was developing a vaccine for the yellow fever outbreak of the early 20th century or the Green Revolution that fed more than a billion people in Latin America and Asia. The challenges of our 21st century world call for no less—particularly as crises continue to outpace our best responses.

Private markets are needed to find and finance forward-looking solutions—and philanthropy is well-suited to help engage new capital, by peeling back the first layer of risk and developing the infrastructure for innovative finance to take root. This is why The Rockefeller Foundation has been an early innovator and funder of the ecosystem for Social Impact Bonds (SIBs), an innovative finance mechanism aimed at scaling social interventions to deliver a measurable benefit for society. From early support for Social Finance UK and the pilot SIB program in Peterborough, UK, the Foundation has committed itself to facilitating the development and testing of this innovative finance model.

Although SIBs are a relatively new tool, it has rapidly garnered support as an innovative approach to financing valuable social programs without putting taxpayer dollars at risk. SIBs are marching closer to achieving "proof of concept," at which point, the sustaining market for SIBs will no longer require philanthropic capital.

But until then, philanthropy will continue to play a pivotal role. Over the last three years, The Rockefeller Foundation has helped to build the SIB ecosystem in the United States by providing planning grants to intermediaries and service providers; funding research focusing on political trajectories, the investor landscape, and social applications; and supporting first-mover mayors' and governors' offices to increase their capacities to negotiate, structure, and execute bonds.

Philanthropy is now looking to the future by exploring possible adaptations of the SIB model to environmental and international development causes. We hope that by collecting and sharing the experiences of various foundations and partners, this report will serve to accelerate the innovation and further development of SIBs for the benefit of the poor and vulnerable, and for the well-being of all humanity, throughout the world.

Judith Rodin

Judith Rodin
President, The Rockefeller Foundation

When John D. Rockefeller created the Rockefeller Foundation in 1913, he never envisioned the innovations of impact investing and Social Impact Bonds (SIBs) that his successors are supporting a hundred years later. His core message, however, lives on: Philanthropy should be deeply engaged as a laboratory of research and development for new paths of social innovation.

My colleagues interviewed thought leaders at 30 different foundations and organizations for this study in order to gather their stories and early experiences for the benefit of the broader philanthropic community. Within this limited sample, they found widespread agreement around the role of foundations in testing innovations such as SIBs. Over and over, foundation program officers and executives remarked on their institutions' willingness and ability to take on risks in support of SIB initiatives, and to seed the emerging market through its early, uncertain stages.

We at Social Finance are deeply cognizant of—and profoundly grateful for—the backing of philanthropic organizations in laying the foundation for the development of the SIB market. Indeed, it would not exist today without the support of these organizations. The first SIBs in both the US and UK were launched thanks to the support of foundations. Most recently, foundation support was vital in the two transactions announced in winter 2013-14 in Massachusetts and New York State, both of which feature substantial participation from major foundations.

At nearly $50 million, the US SIB market is now the largest in the world. Yet, this market is still far from maturity—and still, accordingly, dependent upon foundations that are willing to take on the risks of developing this high-beta, early-stage innovation. Foundations are uniquely capable of taking a long-term view by providing the patient capital that is essential to advancing the use of this innovative financial tool. Moreover, foundations provide much more than money; the thought partnership and intellectual capital that they bring to the table are equally important in shaping the SIB market.

What can philanthropy do now to accelerate progress and drive the development of a standardized, widespread SIB market in the US? And how will the role of foundations evolve as the market evolves? If the role of foundations is to incubate new initiatives, then who expands on their work once the incubation period is over? Is there an exit strategy for foundations, after they have laid the groundwork for a sound and stable SIB market by helping to build an ecosystem, refine the concept, and unlock capital? Or will they remain involved in an advisory capacity, lending their knowledge, integrity, and credibility?

This study sets out to explore philanthropy's role as innovator, funder, investor, and advisor in the SIB market, by drawing on Social Finance's on-the-ground experience as well as the rich and varied contributions of our interviewees and reviewers. We are greatly indebted to those who so generously lent their time, expertise, and wisdom to our work.

We look forward to your feedback and shared learnings.

Tracy Palandjian
CEO, Social Finance, Inc.

Executive Summary

THE US SIB MARKET HAS EVOLVED SWIFTLY FROM CONCEPT TO LAUNCH—DUE IN LARGE PART TO THE CATALYTIC SUPPORT OF FOUNDATIONS.

The provision of social services in the United States has entered a new era marked by two powerful forces: mounting pressure on government and philanthropic resources, and innovation in the social sector. These trends are intertwined; high demand for social services in combination with strained budgets call for innovative approaches to complex social challenges and new ways to finance them. Social innovation financing, especially Social Impact Bonds (SIBs), has emerged as a promising way to finance proven social services programs, fund what works, and drive government accountability.

The US SIB market has evolved swiftly from concept to launch—due in large part to the catalytic support of foundations. What has driven foundations to engage with this new form of social-sector financing? What roles have they undertaken, and how do they view their experience so far? Based on our on-the-ground experience as well as interviews with staff at foundations at all stages of engagement with the market—from observers to the actively involved—we set out to explore these questions in the context of the US market.

Our research indicates that the foundations that have chosen to engage with this nascent market are doing so for a number of reasons and in a variety of ways. They are attracted to the tool's potential to shift funding from remediation to prevention, focus on outcomes, encourage government efficiency, foster collaboration, amplify impact, and deploy capital through program-related investments (PRIs). Many viewed foundation engagement with SIBs as a natural outgrowth of philanthropy's traditional role as an "idea shop" that may take on the risk of proving a concept before it can be scaled by government.

Foundations are choosing multiple channels of engagement. They are supporting the creation of a SIB ecosystem and building a track record for this new tool by:

- ***Making grants*** *to support capacity building among key market participants, conduct research and encourage learning, develop proof-of-concept projects, pay for outcomes, and mitigate risk.*
- ***Investing*** *directly in SIB transactions through PRIs, recoverable grants, and other forms of investment.*

- ***Fostering partnerships*** *among stakeholders by helping to bring together the various and diverse actors in this space, and helping to unite them around shared goals.*

- ***Advocating and educating*** *to influence policy, attitudes, and knowledge, both among the general public and among those directly involved in SIBs, such as government officials and service providers.*

Despite the wealth of activity, substantial challenges remain before the potential of SIBs evolves into the reality of a self-sustaining market. Foundations entering the market are likely to encounter a steep learning curve and a lack of precedent on which to base transactions. Many interviewees expressed concern with the slow progress and unexpected complexity encountered in developing early SIB transactions in the US. Extra effort is required to align the interests of multiple sets of stakeholders. Silos within government across levels (local, state, national) and agencies may further stymie collaboration, while divisions within foundations between the grantmaking and investment sides may impede investment in deals. A lack of standardized, high quality data on the impact of social programs may also present obstacles. Weak data, for instance, could lead to unintended consequences and the misallocation of resources.

Finally, our interviews revealed substantial uncertainty around the long-term vision for SIBs. Specifically, foundation staff questioned how long the market would require philanthropic support and whether the ultimate goal was to hand off social services financing to mainstream impact investors[1] or government. There was much debate over the costs and benefits of credit enhancements in early SIB transactions. Some argued that philanthropy should help to seed the nascent market, but should then seek to hand off SIBs to mainstream impact investors as the market matures. Others believe that foundations bring much more to the market than just capital—they bring knowledge, integrity, and credibility—and thus should remain engaged for the long term.

Indeed, foundations may play a vital role in building a stronger market ecosystem by helping to educate market participants, including government and service providers, on the nuances of SIBs. As widely respected institutions, they are well-positioned to encourage the adoption of better data systems and urge for transparency in SIB contracts and outcomes, which are critical elements in building the industry. Foundations can also draw upon their extensive experience in the social sector to steer the conversation about how pay-for-success strategies can be adapted in different contexts to achieve better results. They can use their deep knowledge of both issue-area research and program operations to provide insight into best practices, and to ensure that individual SIB transactions maximize the opportunity to serve the public good.

Over the near term, the willingness of philanthropic institutions—large and small, corporate, national and community-based—to encourage experimentation and create the building blocks for this new market may go a long way toward realizing its potential: bringing effective programs to many more individuals in need. Further out, foundations may exit the market as the funding of proven social programs increasingly gets taken up by investors or the government. Alternatively, it is possible to envision a future in which mainstream impact investors, governments, and foundations continue to co-fund some SIB transactions for interventions with broad social benefits that may be difficult to monetize. This arrangement would underline the core strength of the SIB model: its ability to facilitate multi-sector, multi-partner collaboration to generate both social and financial benefits.

1 "Mainstream impact investors" in this context refers to institutional investors and high net-worth investors and family offices that make investments to generate financial returns and intentionally improve social or environmental outcomes.

What Is a Social Impact Bond?

A Social Impact Bond is an innovative financing mechanism designed to raise private-sector capital to expand effective social service programs. SIBs are a way to finance pay-for-success contracts, which allow government to pay only for results. If a program funded by SIBs achieves successful outcomes,[2] which are defined and agreed upon in advance by all parties to the contract, government repays investors their principal plus a rate of return based on the program's success.[3] If outcomes are not achieved, on the other hand, government is not obligated to repay investors.

As currently conceived, SIBs are only appropriate for specific problems that meet key criteria. A project is a good candidate for SIB financing if the issue area falls within a policy priority for the participating government and the project has:

- *Strong and committed government leadership with the will and ability to champion the project;*
- *Proven interventions delivered by experienced service providers with the ability to scale up their work;*
- *Potential for high net benefits, such that the anticipated benefits from the program justify the costs of implementation;*
- *Robust data availability and analysis, enabling credible outcomes measurement in a reasonable timeframe, based on a well-defined population of sufficient sample size; and*
- *Safeguards against unintended adverse consequences.*[4]

SIBs are one tool within the wider impact investing market, which offers the potential to draw large sums of private capital to the effort of solving complex social problems. By leveraging a new source of capital to fund social services, impact investing tools like SIBs provide an opportunity to accelerate progress on longstanding issues by scaling up effective programs to reach many more people in need than would be possible through grant or government dollars alone. For foundations that make mission- or program-related investments, this impact can be even more powerful as foundations are able to recycle their capital into other projects to support their missions.

Like other impact investments, SIBs involve the participation of investors who bring market discipline to transactions. Similar to many foundations, these investors conduct due diligence to ensure that participating service providers have a track record of positive results, the management capacity to grow their operations successfully, and a culture of collecting and using data to improve performance. During the course of the project, investors expect intermediaries to provide ongoing performance management and implement midcourse corrections as needed. Further, they require that decisions surrounding repayment be based on accurate social and financial data and transparent performance metrics. Their attention to performance management and tangible, quantifiable evidence drives improved outcomes.

Despite their name, Social Impact Bonds differ from municipal bonds and other fixed-income tools that are often used for infrastructure or other capital projects. SIBs share features of both debt and equity. The instrument has a fixed term and the upside is capped, but, like equity, returns vary based on performance and investors bear a higher risk of losing their principal. Moreover, these investments are not secured by hard assets or cash flows. Despite the dissimilarity to typical bonds, SIBs do in fact possess a number of bond-like characteristics, and it is worth noting that bonds are hardly uniform instruments—they come with different features, from zero-coupon bonds to convertible bonds. Similarly, the structure of each SIB will likely vary from project to project.

2 Historically, government payment to service providers has been based on outputs rather than outcomes. The metrics associated with outputs usually focus on head count, for example the number of people enrolled in a program or the number of families served. Outcomes measurement, by contrast, focuses on the impact of the service with regard to achieving desired benefits, such as the reduction in prison recidivism or the number of people who gain long-term employment as a result of the program.

3 For more information about SIBs, please see the list of resources in Appendix II.

4 Jeffrey Liebman and Alina Sellman, "Social Impact Bonds: A Guide for State and Local Governments" Harvard Kennedy School Social Impact Bond Technical Assistance Lab (June 2013), available at http://hkssiblab.files.wordpress.com/2012/11/social-impact-bonds-a-guide-for-state-and-local-governments1.pdf.

Introduction

SOCIAL INNOVATION FINANCING, ESPECIALLY THE SIB, HAS EMERGED AS A PROMISING WAY TO SCALE PROGRAMS AND REACH GREATER NUMBERS OF INDIVIDUALS IN NEED.

Are Social Impact Bonds the Same as Pay For Success?

SIBs are sometimes equated with pay-for-success (PFS) contracts, but the terms are not synonymous. In fact, PFS refers to a type of contract between government and another entity in which pay is linked to performance. The government may promise to pay a service provider when it places an individual in a job and when this person is still at the job for a year; this is a PFS contract, since pay is contingent upon performance. A SIB, by contrast, is a financing mechanism that supports PFS contracts; the SIB is used to provide upfront funding to service providers engaged in PFS contracts. All PFS-based financing arrangements in the social sector, including SIBs, fall under the wider umbrella of social innovation financing.

Governments at all levels are confronting a new era of scarcity. Coping with the lingering effects of the recession, many states and localities are struggling to meet even the essential needs of their citizens. Governments are facing tough choices between making longer term investments in preventative programs and having adequate funds to focus on near-term challenges.[5] And there is no end in sight: experts predict that federal, state, and local governments will face growing fiscal pressures for the foreseeable future.[6] While philanthropy can help, it too faces substantial funding pressures, and cannot meet the large and growing social needs.

The good news is that innovation in the social sector is flourishing. Social entrepreneurs are crafting new approaches to complex social challenges, and an increasing focus on evaluation and data is producing greater knowledge of what works, what may not work, and why. A growing cadre of investors interested in generating social impact alongside financial return is directing substantial new resources to the sector. Within this sphere, social innovation financing, especially the SIB, has emerged as a promising way to scale programs and reach greater numbers of individuals in need.[7]

The speed with which the SIB market has progressed reflects broad interest in SIBs as one way to address current challenges in financing social services. Although the world's first SIB was launched in 2010 in the UK, additional SIB-financed projects have been initiated or are in the pipeline in a number of US locations, such as California, Connecticut, Illinois, Massachusetts, New York, Ohio, South Carolina, Texas, and Utah. Much of this progress can be traced to the catalytic role that foundations are playing in the development of the nascent market.

5 States, for example, have increasingly relied on spending cuts to balance budgets. Between 2008 and 2012, state budget gaps led to a cumulative $290 billion in across-the-board spending cuts in health, education, and human services. By fiscal year 2012, most states were spending less in real terms than they did in 2008, even though the cost of services had increased. Source: Center on Budget and Policy Priorities, "Out of Balance: Cuts in Services Have Been States' Primary Response to Budget Gaps, Harming the Nation's Economy" (April 2012), available at http://www.cbpp.org/cms/index.cfm?fa=view&id=3747.

6 United States Government Accountability Office, "State and Local Governments Fiscal Outlook: April 2013 Update," available at http://www.gao.gov/assets/660/654255.pdf.

7 While we acknowledge that SIBs may be used to finance new and untested approaches to social challenges, Social Finance believes that the appeal of SIBs lies in their ability to finance the scaling-up of evidence-based interventions. It is important to underscore that SIBs do not replace government spending for social services; rather, they can redirect government spending toward what works. Even when supporting interventions with a track record of success, however, SIBs carry the risk of poor execution related to the scaling-up process itself.

Public and private foundations—those non-governmental organizations established to make grants for charitable purposes—are helping to build the market's infrastructure and demonstrate the tool's capacity. The Rockefeller Foundation invested in the first SIB in the UK and has since made a number of grants in support of building the US market. Bloomberg Philanthropies provided credit enhancement for a SIB in New York City and as a result helped attract the participation of commercial capital. Other foundations are providing operating capital to market intermediaries, funding demonstration projects, and developing deals alongside government officials.

What has driven foundations to engage with this new form of social-sector financing? What roles have they undertaken, and how do they view their experience so far? What are their concerns? How long will philanthropy play a role in the SIB market? Based on our on-the-ground experience as well as interviews with staff at foundations at all stages of engagement with the market—from observers to the actively involved—we set out to explore these questions in the context of the US market.

It is important to note that our interviews were primarily with staff at those foundations that have already begun to explore social innovation financing and therefore do not reflect a random sample of philanthropic organizations (see the sidebar on page 13 for a description of this paper's methodology). Our goal was to collect the early learnings of these pioneers for the benefit of the broader philanthropic community.

This paper is intended for foundation staff, board members, and donors who are interested in this innovative approach to channeling more resources to evidence-based programs, as well as other stakeholders looking to learn about the various ways that foundations may support the market.

We begin by summarizing the current state of foundation engagement in the US SIB market, primarily based on findings from our interviews with a number of foundation staff members. In this section, we explore why foundations have chosen to support this market, and how they have engaged. Based on the roles foundations have played to date, we provide a menu of options for other foundations that may be interested in getting involved. Next, we delve into some of the concerns that foundations may have about SIBs, as well as the obstacles that foundation staff and boards may encounter as they move into the market. We end the paper with reflections on the way forward, including our thoughts on how to optimize foundation participation to build a robust and self-sustaining SIB market in the US.

THE SPEED WITH WHICH THE SIB MARKET HAS PROGRESSED REFLECTS BROAD INTEREST IN SIBS AS ONE WAY TO ADDRESS CURRENT CHALLENGES IN FINANCING SOCIAL SERVICES.

Methodology

In our research for this paper, we leaned heavily upon the previous work of others who have studied this field and in-depth interviews with over two dozen foundation staff members and leaders in the nonprofit sector, as well as our own observations as an active participant in the development of the US SIB market. (See Appendix I for a list of our interviewees.) We endeavored to interview staff at foundations at all stages of engagement with the SIB market—from observers to the actively involved; however, our sample is heavily weighted toward those foundations that have already begun to explore this approach. We also strived to include foundations of different sizes, from opposite corners of the country, and supporting a variety of mission areas. In the end, however, the information that we gathered from these interviews is anecdotal rather than scientific—a varied assortment of opinions rather than a random sample—and we are careful to treat it as such. As one of our interviewees observed, "If you know one foundation, you know one foundation."

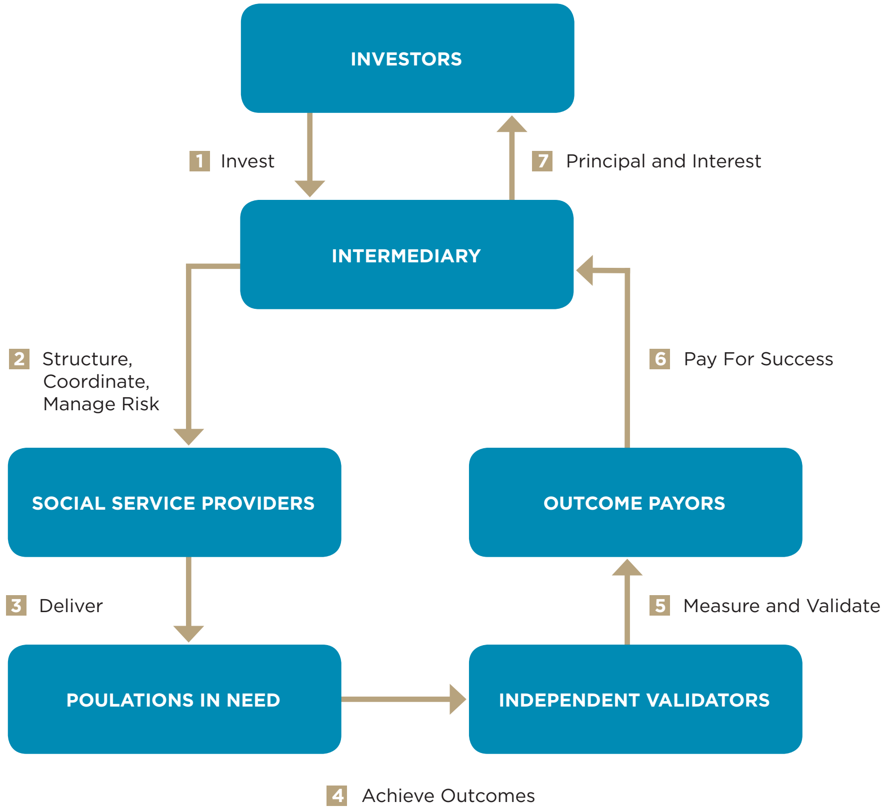
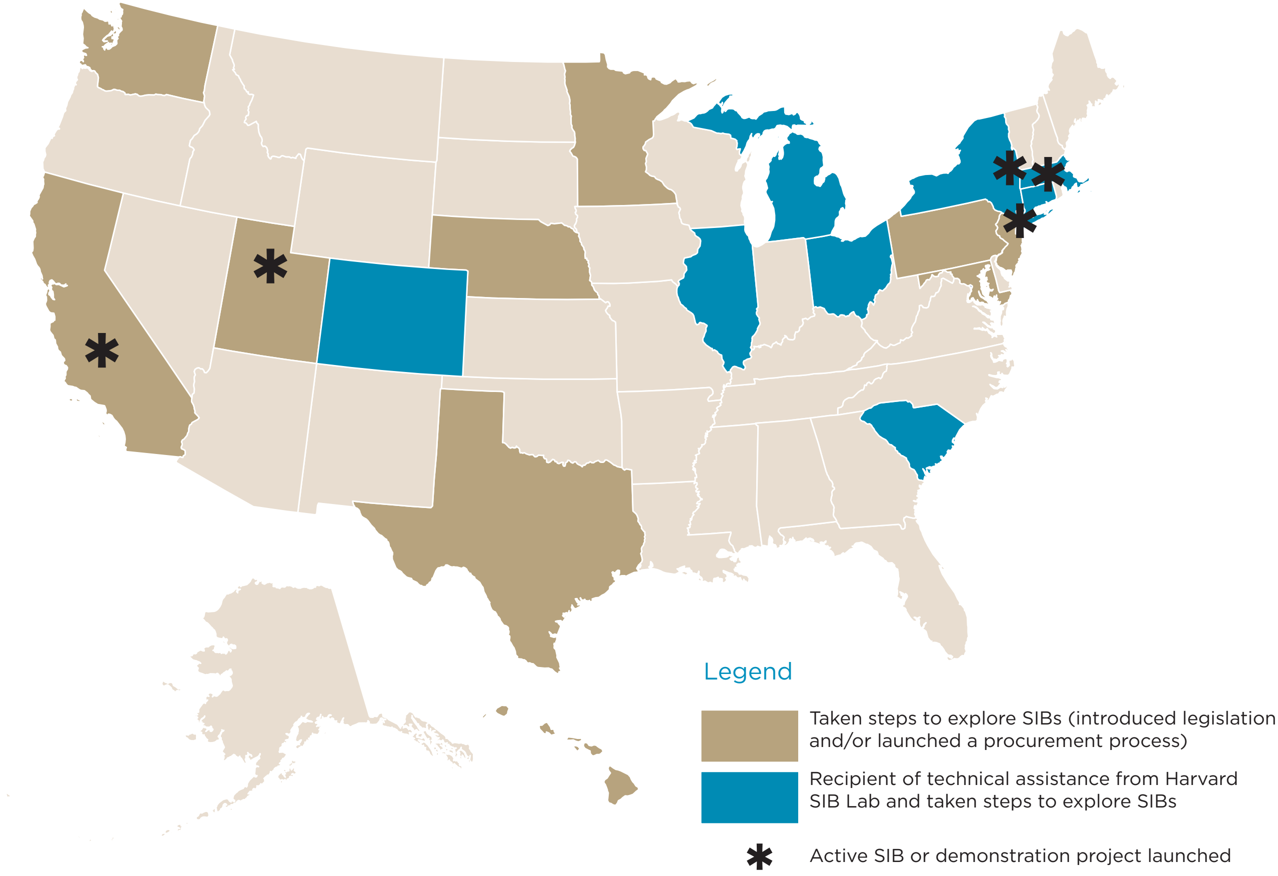


Figure 1. **How a Social Impact Bond works**

WHAT HAS DRIVEN FOUNDATIONS TO ENGAGE WITH THIS NEW FORM OF SOCIAL-SECTOR FINANCING? WHAT ROLES HAVE THEY UNDERTAKEN, AND HOW DO THEY VIEW THEIR EXPERIENCE SO FAR?



Accurate as of date of publication.

Figure 2. **Social Impact Bond activity across the United States**

ALTHOUGH THE WORLD'S FIRST SIB WAS LAUNCHED IN 2010 IN THE UK, SIB-FINANCED PROJECTS ARE IN THE PIPELINE ACROSS THE US. MUCH OF THIS PROGRESS CAN BE TRACED TO THE CATALYTIC ROLE THAT FOUNDATIONS ARE PLAYING IN THE DEVELOPMENT OF THE NASCENT MARKET.

Today's Social Impact Bond Market

The worldwide SIB market was born in the fall of 2010 in the UK, when Social Finance UK launched the first SIB. The SIB-financed program aims to reduce re-offending among men who are released from Peterborough Prison. Experienced social sector organizations will provide intensive support to 3,000 short-sentenced prisoners over a 6-year period, both inside the prison and after release, to help them resettle into the community. If this support reduces re-offending by less than 7.5 percent, the government will not repay investors. If it delivers a drop in re-offending beyond 7.5 percent, investors will receive an increasing return of up to 13 percent based upon the program's success in achieving social outcomes. Investors in the Peterborough SIB are foundations, including the Rockefeller Foundation, and philanthropic-minded individuals and families. Since launching the Peterborough SIB, the UK has remained very active in worldwide SIB development, with more than a dozen on-the-ground projects.

Pilots in the US have emerged more recently. In 2013, New York City became the first American jurisdiction to launch a SIB, and three additional deals have since been announced. The four SIBs that are now on the ground in the US are:

- ***New York City.*** *A $9.6 million project, this SIB directs capital from Goldman Sachs to a program that aims to reduce recidivism among young men exiting the Rikers Island corrections facility.*

- ***Utah.*** *Philanthropist J.B. Pritzker and Goldman Sachs are channeling up to $7.0 million to increase enrollment in a high-quality preschool program in order to reduce the need for special education and remedial services.*

- ***New York State.*** *Over 40 individual, philanthropic, and institutional investors are providing $13.5 million in funding to expand access to a workforce development program for formerly incarcerated individuals in order to boost their employment rates and reduce repeat incarceration.*

- ***Massachusetts.*** *Financed by $18 million in commercial and philanthropic funding, this SIB scales up a program delivered by a local service provider, Roca, to reduce recidivism and improve employment outcomes for young men at high risk of reoffending.*

Altogether, these deals are channeling approximately $50 million in private capital to the social sector, making the US the largest SIB market in the world in dollar terms. A number of other state and local governments are at various stages of exploring SIBs. At the federal level, President Obama has put forth support for pay-for-success initiatives in each of his budgets since 2011. The President's 2014 budget also proposed a new $300 million Incentive Fund at the Department of the Treasury to help state and local governments implement pay-for-success programs.

In addition, SIBs have commanded attention globally. In June 2013, UK Prime Minster David Cameron convened leaders from G8 member states for a Social Impact Investment Forum. Senior politicians, major philanthropists, leading investors, entrepreneurs, and business executives met to discuss the opportunities and challenges of a global impact investment market, and much discussion focused on SIBs.

Findings: Foundation Engagement with the SIB Market

FOUNDATIONS THAT FIND SIBS APPEALING AND WORTHY OF EXPLORATION HAVE A MENU OF OPTIONS FROM WHICH TO CHOOSE. BROADLY, FOUNDATIONS CAN SUPPORT SIBS IN FOUR WAYS: THROUGH GRANTMAKING, INVESTMENTS, PARTNERSHIPS, AND ADVOCACY.

The foundation staff interviewed for this paper highlighted the significant potential that many of them see in SIBs, ways that foundations may add value to the market, and challenges that may impede further activity. The next few sections provide insight into how foundations view the nascent market.

WHY ENGAGE?

Our conversations with a number of foundations point to a substantial level of support for the SIB concept. One interviewee called SIBs an "emerging jewel," while many expressed support ranging from "guarded" to "enthusiastic" for SIBs' potential to drive the expansion of evidence-based social interventions. Many were drawn to the ability of SIBs to provide flexible, patient capital at scale. Foundations that are supporting the development of the SIB market explained their reasons for participation, while others identified what they saw as the tool's most appealing characteristics.

Shift Funding toward Prevention

Many foundations are keenly aware that a significant amount of government resources are allocated toward remediation rather than prevention, and are eager to reverse this trend. The recent recession has forced many governments to make tough spending cuts, often sacrificing investments in programs that produce long-term results to ensure sufficient funds for near-term needs. As one interviewee noted, some governments have not had "the luxury of taking the future into consideration."

Several of our interviewees cited SIBs' emphasis on funding preventative programs as an appealing characteristic; as Frederick Douglass once said, "It is easier to build strong children than to repair broken men." A SIB-financed program has the potential to tackle the root causes of problems rather than just treating their symptoms. For example, a SIB targeting a reduction in asthma could finance asthma management education and the removal of home environmental triggers to reduce the need for emergency medical treatment. Indeed, the focus on prevention is really the financial engine that drives the SIB. Preventative services are designed to eliminate or vastly reduce the need for future spending on treatment services downstream, redirecting a revenue stream that enables government to repay investors.

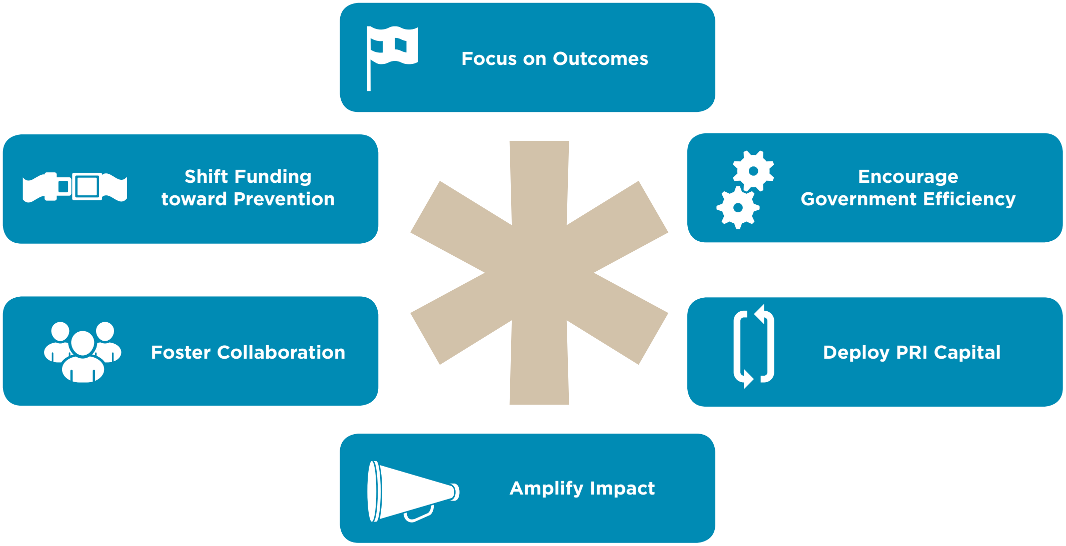


Figure 3. **Why foundations are engaging with Social Impact Bonds**

As one interviewee noted, the values of funding prevention and promoting government efficiency are not new concepts. But SIBs "raise the stakes," since actually accomplishing these objectives is no longer "a good idea or aspiration—real money is on the line."

Focus on Outcomes

SIBs' focus on outcomes was another oft-cited benefit. This focus aligns with growing interest from government, philanthropy, and the social sector in data collection, evaluation, and performance-based contracting. One interviewee commented that SIBs' "hard-nosed" approach—only rewarding what works—aligns with her foundation's interest in expanding evidence-based practices in the social sector. Because they focus on results, SIBs are not prescriptive, noted another interviewee; instead of financing a specific quantity and set of services, they allow for flexibility in service provision. This allows for "a more comprehensive approach to complex problems." An intermediary may coordinate multiple services for clients in order to meet their needs and achieve target outcomes. SIBs also commit the government and social sector to think about assessing outcomes, such as high school graduation rates, beyond the more common practice of measuring outputs, such as program completion.

Moreover, SIB-financed projects incorporate a strong component of performance management. Intermediaries and service providers manage the project closely, evaluating data on a regular basis and implementing midcourse corrections as needed. In this way, projects can evolve and adapt in order to deliver the greatest benefits.

Some foundations perceive the focus on outcomes as an important development in the social sector. They are looking beyond SIBs to the broader field of pay-for-performance. For instance, the Kresge Foundation believes that pay-for-performance structures may play an important role in service delivery going forward. To test the efficacy and efficiency of different structures, it is involved in a pilot set of pay-for-performance transactions that tie directly to the foundation's programmatic interests.

Encourage Government Efficiency

Because SIBs allow government to pay only for results, they encourage greater efficiency within the public sector. Despite growing attention to evidence in the social sector, historical funding patterns, legacy interests, and short political cycles often impede the reallocation of public dollars to the most effective interventions. Several of our foundation interviewees cited the potential of SIBs to increase accountability for taxpayer dollars. SIBs allow governments "to buy a result rather than a process," noted one interviewee. Where payments are determined by data, the public sector is assured of getting real value for its money.

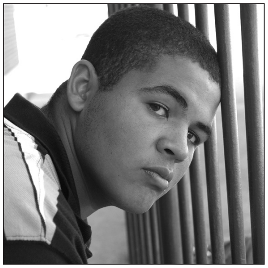
This holds potential for governmental work beyond SIBs. As government officials become comfortable with the concept of pricing social outcomes, they may be more likely to incorporate outcomes data into decision-making over a broad range of areas. This should encourage efficiency by emphasizing the value of prevention over remediation, facilitating cost-benefit analysis of various interventions, and encouraging government to make evidence-based funding decisions.

Foster Collaboration

Many of our interviewees also viewed with great favor the ability of SIBs to promote collaboration; one commented, "Foundations really like to partner." By definition, SIBs draw together a number of stakeholders—government agencies, private-sector investors, service providers, beneficiaries, and intermediaries—working toward a shared purpose.

While SIB-financed projects foster cross-sector collaboration, they also have the potential to enhance the quality of these collaborations. Not only does a SIB assemble various stakeholders, but its success requires close and collegial cooperation among them. Any SIB involves internal tensions among stakeholders, and a successful transaction requires that stakeholders' incentives are aligned. In fact, each party effectively has a veto over every aspect of the enterprise. If any of them exercises that veto during the design phase, the SIB will not launch; if any of them does so during implementation, the SIB will not work. If the parties want the SIB to launch and to succeed, they have to reach consensus at the outset and maintain consensus over the life of the project.

This dynamic tension is the reason that SIBs have the potential to produce significantly greater social progress at substantially reduced expense. The system of checks and balances under the umbrella of the SIB partnership prevents any party's self-interest from undermining the pursuit of shared objectives, and keeps the partners' diverse interests in alignment.



INDEED, THE FOCUS ON PREVENTION IS REALLY THE FINANCIAL ENGINE THAT DRIVES THE SIB. PREVENTATIVE SERVICES ARE DESIGNED TO ELIMINATE OR VASTLY REDUCE THE NEED FOR FUTURE SPENDING ON TREATMENT SERVICES DOWNSTREAM, REDIRECTING A REVENUE STREAM THAT ENABLES GOVERNMENT TO REPAY INVESTORS.

For example, a government participating in a SIB may agree to a performance benchmark that incentivizes key stakeholders in the following ways:

- *The benchmark is within reach of the participating service provider, making it more likely that investors will be repaid.*

- *The benchmark is high enough to create meaningful social value for the public sector.*

Accordingly, by working together, these parties can draw upon the strengths of one another to pursue a common goal.

Amplify Impact

Foundation staff underscored the appeal of using SIBs to advance progress on their mission. Many interviewees noted that participation in this new market could enhance their ability to achieve substantial impact on key areas of interest. By raising investment capital, SIBs deploy a significant new stream of funds that allows service providers to scale up their programs and reach many more individuals. As one interviewee noted, SIBs are feasible only because of recent advances in impact investing; the emergence of a growing community of investors with an interest in applying capital to achieve both financial returns and create social benefit has unlocked access to resources that "increase the pie" for the social sector.

Our conversations suggest that SIBs resonate with foundations differently depending on the nature of the alignment with their mission statements. Broadly, mission alignment falls into three categories:

- ***Program area.*** *SIBs may bring a deep pool of capital to support foundations' program priorities. For example, the Joyce Foundation has deployed grant capital to fund exploration of ways in which SIBs might further its efforts in the area of workforce development, and the W.K. Kellogg Foundation is examining SIBs as a way to enable its grantees to increase their positive impact on vulnerable children.*

- ***Geography.*** *SIBs can tap resources that may be used to benefit geographies of interest. The Dunham Fund made a grant to help bring SIBs to Illinois as part of its commitment to support organizations in its community, and the James Irvine Foundation co-launched an initiative to catalyze the development of pay-for-success agreements in California.*

- ***Financial innovation.*** *Foundations may be interested in SIBs primarily for their potential to apply a new financing approach to the provision of social services. The Edna McConnell Clark Foundation, for example, is helping its grantees explore SIBs as a way to connect to a large and renewable source of funding.*

While foundations are encouraged by the potential of SIBs to amplify their impact, they also recognize that SIBs are complex and largely untested, have potential only in certain settings, and are hardly a panacea for all social challenges.

WHILE FOUNDATIONS ARE ENCOURAGED BY THE POTENTIAL OF SIBS TO AMPLIFY THEIR IMPACT, THEY ALSO RECOGNIZE THAT SIBS ARE COMPLEX AND LARGELY UNTESTED, HAVE POTENTIAL ONLY IN CERTAIN SETTINGS, AND ARE HARDLY A PANACEA FOR ALL SOCIAL CHALLENGES.

CASE STUDY

The Rockefeller Foundation: A Leader in SIB Ecosystem Development

The Rockefeller Foundation has played a strong leadership role in fostering the development of the SIB market. Starting in 2009 when the foundation made a grant to Social Finance UK to explore social innovation financing, it has been drawn to SIBs because of their intersection with impact investing and innovation, two areas of strong programmatic interest. In 2010, the foundation became the only US institution to invest in the Peterborough SIB.

As interest in the concept was escalating in the US, foundation staff believed that they could leverage the knowledge gained through their investment in the Peterborough SIB to contribute to market growth domestically. Kippy Joseph, an associate director of innovation at the Rockefeller Foundation, observed, “With every SIB, the devil is in the details. Having the firsthand experience of being in the [Peterborough] partnership was almost irreplaceable in terms of the insight that would benefit us in thinking about the US market.”

To catalyze the growth of the US market, Rockefeller has deployed nearly $10 million as part of a deliberate strategy that focused on moving SIBs from concept to pilot. In its first grants, it provided operating support to various industry players with the recognition that it would take time before market actors could finance efforts on their own. This support was comprehensive, designed to strengthen various strands of the market simultaneously. Rockefeller’s grants have seeded the field-building activities of intermediaries, government advisors, researchers, and educators, among others. To advance learning, for instance, Rockefeller provided grants to the Nonprofit Finance Fund (NFF) to create a website serving as an information platform on SIBs. It has also funded work by the Center for American Progress to develop educational materials and conduct outreach aimed at sparking a bipartisan dialogue on the topic among federal policymakers.

Over time, the foundation has endeavored to use its support to increase the comfort level with SIBs among commercial investors. Toward that end, it provided Social Finance US with a grant for credit enhancement for a specific SIB transaction. (See sidebar on page 46 for more information.) By sequencing its support in this way, the Rockefeller Foundation aims to help the market become less reliant on philanthropic support over time. Scaling SIBs with new funding sources allows prevention-oriented services to be available to vulnerable communities and prevents more expensive social problems down the line—impact the foundation seeks in its grantmaking strategy.

In addition to monetary support, the foundation has played a key networking and education role in the SIB market. Joseph explained, “As with every network, [the SIB market] really requires a network weaver to make sure that information flows freely and that while every actor is playing his or her own part in the ecosystem, there’s some sense of moving in the right direction all together. Rockefeller in some ways has played that role.” It has supported knowledge-building efforts, for instance, by connecting NFF with the White House Domestic Policy Council to shape a strong agenda for a White House convening on pay-for-success initiatives. It has also facilitated introductions between foundations and organizations working on projects of overlapping interest, and held numerous conference calls to advance learning.

Overall, Joseph characterizes the Rockefeller Foundation’s experience of creating an enabling environment for SIBs as both gratifying and challenging. She is encouraged by the energy and commitment that she sees among the various actors in the market. At the same time, assembling stakeholders from different groups and translating among them can be challenging. Ultimately, Joseph views its cross-sector, systems-level strategy as vital to realizing what the Rockefeller Foundation has identified as the real promise of SIBs: to shift more funding from remediation to prevention, enable government to use taxpayer money for successful services for vulnerable people, and unlock private capital for social benefit.

Founded in 1913, the Rockefeller Foundation’s mission is to promote the well-being of people throughout the world. It has approximately $3.5 billion in assets.

Program-Related Investments: A Primer

Private foundations are required by the IRS to give away at least 5 percent of their endowments annually, and typically invest the other 95 percent in debt, equity, and other financial instruments to maximize returns that enhance the size of their endowment. Program-related investments (PRIs) offer the opportunity for foundations to deploy their funds in a different way: as investors in socially beneficial projects.

PRIs are one form of mission investing, which refers to all investments by charitable foundations that generate both a social and financial return. Mission investments have the advantage of magnifying the impact of philanthropic dollars by providing an opportunity to earn repayment of principal plus a financial return. Thus funds can be recycled, and used to seed multiple initiatives over time.

The mission investing umbrella includes two types of tools: mission-related investments (MRIs) and PRIs. MRIs are funded from investment assets alone; they must meet the applicable prudent investor standards, and are expected to earn a market-rate financial return plus achieve social impact in line with the mission of the foundation. By contrast, PRIs are investments that may be funded from either program or investment dollars to achieve specific program objectives and are expected to return capital, often with modest returns. The IRS regulates the use of PRIs among private foundations. Although they are not subject to the same regulations, community foundations that make mission investments tend to think of them in similar categories.

Since the Ford Foundation pioneered the use of PRIs in 1968,[8] the PRI market has made considerable strides but remains limited in size and scope. In 2009, foundations made over $700 million in PRIs, compared to less than half as much a decade earlier. However, this is miniscule compared to the $40 billion in grants that foundations deployed in 2009.[9] For the past two decades, only about 1 percent of US foundations made PRIs each year.[10]

The decision of whether or not to engage in PRIs is individual to each foundation, depending mostly on its appetite for risk and innovation as well as its staff capacity and board approval. The relatively low level of PRI activity is due in part to the limited number of viable investment opportunities, high transaction costs, and thin market infrastructure. Moreover, a PRI program requires a skill set that blends mastery of financial analysis with social impact awareness and assessment—a highly unusual combination in most foundations, where program and investment staff tend to operate separately from one another.

Figure 4. **Growth in program-related investments in the United States**

Source: Lilly Family School of Philanthropy, Indiana University, "Leveraging the Power of Foundations: An Analysis of Program-Related Investing" (May 2013). PRI data comes from the IRS Statistics of Income (SOI) dataset.

8 The Ford Foundation, "Program-Related Investment," available at http://www.fordfoundation.org/grants/program-related-investment.

9 Foundation Center, "Foundation Growth and Giving Estimates: Current Outlook" (2010), available at http://foundationcenter.org/gainknowledge/research/pdf/fgge10.pdf.

10 These figures reflect the most recent data available. Source: Lilly Family School of Philanthropy, Indiana University, "Leveraging the Power of Foundations: An Analysis of Program-Related Investing" (May 2013), available at http://www.philanthropy.iupui.edu/files/research/complete_report_final_51713.pdf.

Deploy PRI Capital

By facilitating investments aimed at reducing homelessness, lowering prison recidivism rates, and addressing other persistent social challenges, SIBs provide another avenue for foundations to make program-related investments (PRIs). To date, most PRIs have directed foundation capital to bricks-and-mortar projects such as affordable housing and community facilities. (For a primer on PRIs, see the sidebar on page 22.) SIBs offer an opportunity for foundations to diversify their PRI portfolios by facilitating direct investment in human capital.[11] In this way, SIBs expand the available options in the PRI universe. Over time, SIBs may also become viable candidates for mission-related investments (MRIs), market-rate investments made out of foundation endowments.

The sense that foundations can assume risk that others cannot[12] was widespread in our small sample—as was enthusiasm for exploring new, innovative forms of financing for the social sector. The first SIB deals will be opportunities to learn, one respondent observed. Some project components will work while others will require adjustment. But foundations can absorb some of the burden of failure, from which market participants can learn a great deal. Another program officer added, "I don't see the SIB market developing without foundations. Any innovation is inherently unproven at its inception, and that's where we are now."

ONE PROGRAM OFFICER EXPLAINED HER INTEREST IN SIB PILOTS BY COMMENTING, "WE HAVE THE CHARGE TO UNDERWRITE INNOVATION, TO TEST NEW MODELS IN WAYS THAT ARE MUCH HARDER FOR OTHER ACTORS LIKE GOVERNMENT TO DO."

HOW TO ENGAGE

All of our interviewees considered foundation engagement with the SIB market to be valuable, regardless of whether their organization was playing an active role. Many expressed the belief that foundations should take risks to test innovations like SIBs. One program officer explained her interest in SIB pilots by commenting, "We have the charge to underwrite innovation, to test new models in ways that are much harder for other actors like government to do."

Indeed, this would reflect the traditional role of philanthropy as a research-and-development entity that works to prove a concept before it can be scaled by government. While this relationship was strong in the past, in recent decades it has been lacking. Restoring this dynamic would enable foundations to seed the SIB market with an eye to handing it off to other stakeholders, like government, over time.

11 Economists generally consider expenditures on housing, training, and health care as investments in human capital, which are aimed at raising earnings, enhancing health, and improving lifestyle choices.

12 At the same time, the fact that foundations have the ability to take on risks does not mean that they necessarily are willing to do so. In particular, some foundations feel that they should not be the only participant to take on risk in SIB transactions.

Foundations that find SIBs appealing and worthy of exploration have a menu of options from which to choose. Broadly, foundations can support SIBs in four ways: through grantmaking, investments, partnerships, and advocacy.

Grantmaking

Foundations can deploy grants to facilitate the ultimate development of a robust SIB market. Foundations can guide the market's evolution by providing grants to build capacity among key participants, conduct research and encourage learning, develop a proof of concept, pay for outcomes, and mitigate risk.

Build Capacity among Key Participants

- **Service providers.** Many service providers across the country oversee innovative programs that convey lasting benefits to individuals in need. However, relatively few organizations have had the opportunity to document their impact, which in turn limits their ability to attract investment. Foundations can support capacity building within service providers to improve their data collection practices and fund program evaluations in an effort to build their evidence base. Analysis of program costs versus benefits would also be helpful in clarifying the value that the services convey. Foundations that help organizations clearly demonstrate their performance can create a robust pipeline of growth-ready nonprofits—in turn, paving the way for these organizations to participate in social innovation financing transactions such as SIBs. This type of support aligns with broader efforts to foster a more data-driven social sector.

- **Intermediaries.** SIB market intermediaries play an integral role in developing, launching, and managing SIBs as well as conducting research and education to help build the market. They add value by engaging in any or all of the following activities:

  - *Research and test potential applications for SIBs,*
  - *Coordinate and align the interests of stakeholders,*
  - *Structure investments,*
  - *Support the capital-raising phase of the project, and*
  - *Provide technical assistance to service providers.*

  Intermediaries can be particularly helpful in bridging the cultural divide between investors and government, as well as in ensuring that the interests of the populations being served are protected. Over time, intermediaries—many of which are nonprofits themselves—may earn fees on SIB deals that are sufficient to cover the costs of their operations. In the meantime, foundations can support these firms as they contribute to the development of the SIB market.

FOUNDATIONS THAT HELP ORGANIZATIONS CLEARLY DEMONSTRATE THEIR PERFORMANCE CAN CREATE A ROBUST PIPELINE OF GROWTH-READY NONPROFITS—IN TURN, PAVING THE WAY FOR THESE ORGANIZATIONS TO PARTICIPATE IN SIBS.

CASE STUDY

The Pershing Square Foundation and Omidyar Network: Building Capacity within the SIB Market

The Pershing Square Foundation and Omidyar Network were two of the first foundations to support the development of the US SIB market. Additionally, Omidyar Network has supported Social Finance UK to explore the use of SIBs in an international context. Both organizations were drawn to the potential of SIBs to open up a new source of capital to fund social change. Paul Bernstein, CEO of The Pershing Square Foundation, noted that his foundation was particularly interested in the opportunity to deploy market forces to drive progress in the social sector. Amy Klement, a partner at Omidyar Network, agreed and added that SIBs have the potential to change the way that government functions. She also highlighted the tool's need for a solid evidence base, which she said the philanthropic sector can encourage and support. "Foundations can play a role in identifying the areas of potential for SIBs," she explained, "and then funding a grant to do a pilot program collecting the base case data."

Both foundations have made grants to support the growth of the US SIB market, including providing operating capital to intermediaries and other players working to develop the space. As Bernstein commented, The Pershing Square Foundation's interest is in building capacity among organizations that are, in turn, building the market. For its part, Omidyar Network supports a "sector-based" approach—encouraging systemic evaluation that encompasses an entire industry or sector and not just an individual firm or idea. Accordingly, both foundations made founding grants to Social Finance US, a SIB intermediary organization. In addition, Omidyar Network also made a grant to McKinsey & Company to fund research on the SIB market.

Both foundations have also contributed human capital—their expertise, connections, and deep knowledge—to support the development of the market. Bernstein and Klement are observers on the board of Social Finance US, and their foundations contribute technical assistance as needed. The Pershing Square Foundation and Omidyar Network have been active in helping Social Finance build its board, and Omidyar Network assists the organization with its human capital development. This work underlines the fact that foundations bring more than money to the SIB market; they also bring a vast pool of knowledge and non-financial resources that are equally valuable in moving the market forward.

The Pershing Square Foundation, based in New York, was founded in December 2006 by Karen and Bill Ackman. Bill is the CEO and Portfolio Manager of Pershing Square Capital Management, L.P. The Pershing Square Foundation has committed $225 million in grants and social investments to support exceptional leaders and innovative organizations that tackle important social issues and deliver scalable and sustainable impact.

Established in 2004 by eBay founder Pierre Omidyar and his wife Pam, Omidyar Network is a philanthropic investment firm dedicated to harnessing the power of markets to create opportunity for people to improve their lives. It has more than $275 million in assets.

CASE STUDY

Laura and John Arnold Foundation: Supporting Social Innovation Financing to Enhance Public Accountability

In recent years, cities and states across the US have struggled to balance their budgets. They have been forced to cut services, eliminate positions, and implement hiring and wage freezes. Treasurers and comptrollers have been asked to scrutinize every penny, and elected officials have had to decide which programs to keep. While the current fiscal environment has presented a number of challenges, it has also provided an opportunity to reorient government spending around outcomes and innovation. Policymakers now have a new tool, social innovation financing (SIF), which can be used to improve services to address social issues.

Laura and John Arnold Foundation (LJAF) believes SIF can help reallocate limited resources toward proven interventions that help those with the greatest needs. The private foundation, with offices in Houston and New York City, is known for its use of data and analytics to help solve some of society's most urgent and persistent problems—an approach The Wall Street Journal termed "the new science of giving." As part of LJAF's focus on public accountability, it has invested $8.4 million in SIF projects. "We identify challenges and address their root causes through innovative, multi-disciplinary solutions," LJAF vice president of public accountability Josh McGee explained. "SIF is exactly that type of tool. It has the potential to change the way government operates and provides services to those who need them the most. Private investors cover the cost of a program upfront, and the government only pays if the program is actually shown to make a difference."

LJAF provides support for the Harvard Kennedy School's Social Impact Bond (SIB) Technical Assistance Lab, the Social Impact Partnership in New York State (see page 46 for a detailed description of the project), and the Massachusetts Juvenile Justice Pay for Success Initiative. The projects in New York and Massachusetts will provide services to individuals at risk of returning to prison, and any returns on LJAF's investment will be used to support future SIF projects with the goal of rigorously evaluating programs and scaling those that are proven to have an impact. LJAF's commitment to SIF is an extension of the foundation's work in evidence-based policy-making. In 2013, the foundation committed $29.8 million to organizations that are working to encourage and facilitate government decision-making based on rigorous research and evaluation.

"By focusing on evidence and studying 'what works,' governments can ensure that taxpayer dollars are allocated in the smartest, most efficient way," McGee explained. "SIF, and its emphasis on prevention, can help transform the way government works. The tool promotes a shift from stagnant and underperforming policies toward proven and efficient programs—a practice that, regardless of the economic climate, is always fiscally sound."

Founded in 2008, the Laura and John Arnold Foundation's core objective is to produce substantial, widespread, and lasting reforms that will maximize opportunities and minimize injustice in our society.

- **Government.** Government agencies engaging in SIB development can benefit from external support in designing and implementing this unique type of public-private partnership. To support government's engagement with the model, the Rockefeller Foundation provided a grant funding the creation of the Harvard Kennedy School SIB Technical Assistance Lab, which provides pro bono technical assistance to localities that are preparing to launch SIB projects. The SIB Lab has supported SIB development work in New York State and Massachusetts, among other geographies. In early 2013, it launched a nationwide competition for other localities interested in gaining its assistance with SIB development. The SIB Lab received 28 applications, indicating widespread interest in SIBs within the public sector, as well as the desire to benefit from external expertise. It selected and is actively working with 10 governments. In addition to the Rockefeller Foundation, the Dunham Fund and the Laura and John Arnold Foundation are supporting the SIB Lab's efforts.

THE ROCKEFELLER FOUNDATION PROVIDED A GRANT FUNDING THE CREATION OF THE HARVARD KENNEDY SCHOOL SIB TECHNICAL ASSISTANCE LAB, WHICH PROVIDES PRO BONO TECHNICAL ASSISTANCE TO LOCALITIES THAT ARE PREPARING TO LAUNCH SIB PROJECTS.

Conduct Research and Encourage Learning

- **Market research.** Foundations may foster learning by funding research on the SIB market. A number of foundations, including the F.B. Heron Foundation, Omidyar Network, the Robert Wood Johnson Foundation, Rockefeller Foundation, William and Flora Hewlett Foundation, and W.K. Kellogg Foundation, supported McKinsey's 2012 report on SIBs, which outlined the US market's potential.[13] Other studies of the market could explore how pay-for-success strategies may accelerate scale in the social sector or how they can be best integrated with existing public funding streams. Lessons learned from early-stage SIB projects could also be catalogued.

- **Feasibility studies**. Not all social programs are suitable for SIB financing. Foundations can fund feasibility studies to identify a fit between the social need and the tool. Intermediaries are well positioned to carry out this analysis, which could include an assessment of the social problem, examination of evidence-based interventions, identification of growth-ready service providers, and modeling of a potential transaction's economics. Foundations may choose to support feasibility studies as a way to examine whether SIBs can help them magnify their impact within a given program area or for a target geography.

- **Information hubs.** Given the relative youth of the SIB market, a central source of neutral information about SIBs is valuable. Toward that end, the Rockefeller Foundation,

13 McKinsey & Company, "From Potential to Action: Bringing Social Impact Bonds to the US" (2012), available at http://mckinseyonsociety.com/downloads/reports/Social-Innovation/McKinsey_Social_Impact_Bonds_Report.pdf.

the William and Flora Hewlett Foundation, and the Joyce Foundation funded the Nonprofit Finance Fund (NFF) to serve as an information source on the pay-for-success model. NFF hosts a website that aggregates resources on the topic and provides assistance to service providers, government, and other stakeholders exploring this type of financing. Other foundations may consider funding complementary initiatives, such as an affinity group that connects stakeholders with an interest in this space.

Develop a Proof of Concept

- **Support demonstration projects.** With the SIB market still relatively new and untested, it is important that stakeholders maximize projects' probability of success by selecting interventions with a strong record of improving individuals' lives. Toward building a pipeline of SIB-ready interventions, a foundation may fund a demonstration project to identify scalable models for SIBs and create an evidence base from which a SIB could be designed. The California Endowment provided such a grant to Social Finance US and Collective Health for a demonstration project to fund asthma management services in Fresno, California. (See page 29 for more information on The California Endowment's support of a SIB demonstration project.) Demonstration projects may be a valuable way to improve the evidence base for interventions to support the launch of a SIB in a specific geography and facilitate its replication elsewhere.

- **Subsidize early-stage projects.** Early-stage projects can carry relatively high transaction costs, as well-established templates do not yet exist and risks are not yet well understood. To help overcome this obstacle, foundations can support SIB market development by bearing some of the costs of early-stage projects. For instance, a foundation can fund the evaluation or intermediary cost of a particular SIB deal. To support the New York City SIB transaction, Bloomberg Philanthropies made grants to MDRC, which is serving as the program intermediary, and the Vera Institute of Justice, which is providing evaluation services. One interviewee observed that support of intermediaries is especially useful in early-stage deals, since these projects may not be large enough to cover fixed costs.

WITH THE SIB MARKET STILL RELATIVELY NEW AND UNTESTED, IT IS IMPORTANT THAT STAKEHOLDERS MAXIMIZE PROJECTS' PROBABILITY OF SUCCESS BY SELECTING INTERVENTIONS WITH A STRONG RECORD OF IMPROVING INDIVIDUALS' LIVES.

Pay for Outcomes

Another way to address the high cost of early transactions is for a foundation to take on all or part of the cost of paying investors if outcomes are achieved in specific SIB transactions. While governments are currently playing the role of "payor," foundations can consider contributing to investor payments or substituting for governments in this role. By supplementing

CASE STUDY

The California Endowment: Demonstrating the Value of Upfront Funding in Chronic Health Management Programs

In March 2013, The California Endowment (TCE) made a grant of $660,000 to support Social Finance US and Collective Health in launching the first phase of a demonstration project in Fresno, California. Fresno has a particularly high incidence of asthma with about 20 percent of children suffering from the chronic disease. In line with its mission to improve health outcomes in California, TCE made this grant to fund asthma home care and education for the families of 200 low-income children suffering from asthma. These proven asthma management strategies, which focus on reducing environmental triggers, are typically not funded by health insurers despite numerous studies that demonstrate their effectiveness in improving health outcomes for asthma sufferers. Without proper management, asthma can lead to unnecessary and expensive emergency room visits and hospitalizations, and can impede learning through missed days of school.

Through this project, Social Finance and Collective Health aim to demonstrate the social and economic benefits of investment in upfront asthma management services. Insurance claims data collected over the course of the project will document the cost savings due to program participants' reduced need for emergency care. The data will serve as evidence to support the case for scaling the program to reach many more children in need. In addition to overseeing the provision of asthma management services, the partners will convene an advisory group, which will work to design a SIB to scale up the program after the demonstration project is complete.

Anne Stuhldreher, a senior program manager for strategic initiatives at TCE, noted that support for this project involved substantial dialogue within the foundation. TCE program staff weighed where it could best lend value to emerging innovations in social financing. Ultimately, TCE decided to start with a small demonstration project that Collective Health and Social Finance proposed. By focusing on one locale and a programmatic area where TCE and its partners have a high level of expertise and experience, everyone involved hopes to eventually achieve scale through a social investing strategy. "If this leads to the first SIB in California, we want to lay the groundwork for it to be successful. The project wasn't ready for a SIB 6 months ago, but we hope it will be after 18 months of operations. An approach that went slower made sense for us," Stuhldreher explained.

Established in 1996, The California Endowment is a private foundation committed to expanding access to quality health care for the underserved statewide, and improving the health of all Californians. It has approximately $3.7 billion in assets.

	GRANTMAKING	INVESTMENTS	PARTNERSHIPS	ADVOCACY
Capacity building among key participants	✓			
Research and learning	✓		✓	✓
Demonstration projects and pilots	✓	✓	✓	✓
Payment to SIB investors	✓			
Risk mitigation	✓	✓	✓	✓

Figure 5. **How foundations can add value to the Social Impact Bond market**

outcomes payments made by government, foundations can facilitate scaling up of pilot projects. Foundations that pay for SIB outcomes can help bring more SIBs to market and ultimately support the creation of a track record that will be useful in attracting commercial capital to future SIB-financed projects.

Although this paper examines the US market, the UK Big Lottery Fund (BIG) provides an interesting example of how a foundation can help support the payment of outcomes. BIG committed funds for outcomes payments related to the Peterborough SIB as part of its effort to stimulate government demand for the tool and champion innovation. This commitment supplements the UK Ministry of Justice's agreement to pay for outcomes on the same transaction. While it is technically a public body, BIG operates similarly to a foundation, distributing grants of approximately £750 million per year for charitable purposes.

Foundations could pay for outcomes where governments are reluctant to participate. For instance, they could pay to expand programs that produce valuable outcomes but do not deliver net benefits within an investor-friendly timeline. Early childhood programs, among other interventions, may be good candidates for this approach because many of the benefits occur further down the line.

Mitigate Risk

Another role foundations can play is to encourage investors to direct capital into the SIB market by mitigating risk through credit enhancement of transactions. Credit enhancement decreases the financial risk of specific SIB transactions for mainstream impact investors, thus lowering the cost of capital. Credit enhancement can take the form of a financial guarantee of mainstream impact investors' capital, or a subordinated position in a transaction. In addition to grants and recoverable grants, PRIs can also be used to provide credit enhancement. The first US SIB involved credit enhancement in the form of Bloomberg Philanthropies' partial guarantee of Goldman Sachs' capital. (See page 34 for more information on Bloomberg Philanthropies' involvement with the New York City SIB.) In a SIB financing early childhood education in Utah, philanthropist J.B. Pritzker is providing a subordinated loan of up to $2.4 million to reduce the financial risk of Goldman Sachs, which is investing up to $4.6 million.

Given the lack of long-term data and experience at this early stage in market development, such credit enhancement may be desirable in some SIB transactions to help attract commercial capital. Bringing private investors into these early projects lays the groundwork for SIBs' eventual self-sustainability.

Investment

Using PRIs, foundations can become investors in the SIB market. Laura and John Arnold Foundation, for instance, made a philanthropic investment through a PRI in the New York State SIB transaction. (See page 26 for more information on the Laura and John Arnold Foundation's participation in the SIB market.) PRIs can fund entire SIB pilots, or they can be combined with commercial capital or grant money to finance transactions. When combined with investment by mainstream impact investors, foundations making PRIs can help absorb some of the costs of early transactions by accepting a lower rate of return. By investing in early-stage deals, foundations can help create proof points in the market, paving the way for commercially oriented capital to enter the space over time.

As the market matures, SIBs may be viable candidates for MRIs. They may pass the test of fiduciaries overseeing institutional assets, including foundations making MRIs, enabling access to a deep pool of capital that can be drawn upon to finance larger efforts. For the moment, staff at most of the foundations that we interviewed believe that PRIs are the appropriate vehicle for foundations wishing to invest in the SIB market.

Partnerships

Foundations can also support the development of the SIB market by fostering partnerships among stakeholders. Philanthropic organizations' deep knowledge of various stakeholders in the field—service providers, government, and intermediaries—positions them to gather the right actors to the table and facilitate meaningful conversations. Foundations can leverage this knowledge to help build constituencies that support the expansion of preventative services and evidence-based programs. They can also build on their role as conveners in various communities—both geographic and programmatic—to explore PFS partnerships with government, investors, and service providers. One interviewee noted that community foundations have a special ability to convene groups based on their deep knowledge of local issues and stakeholders.

A foundation that has worked to advance SIB partnerships among multiple sectors is the the J.B. and M.K. Pritzker Family Foundation. In March 2014, the foundation is sponsoring a convening to help stakeholders understand and develop pay-for-success contracts funding early childhood programs. The conference brings together leaders from government, finance, and the social sector, among other fields, to explore issues such as data needs, evidence, potential financing structures, and policy and legislative concerns.

Advocacy

Finally, foundations can play a role in advancing the SIB market by helping to educate key stakeholders, especially lawmakers and government officials. SIB education includes not only an explanation of how the tool works, but also the reasons for engaging with this new tool, what a developed market might look like, and why good data matters. This educational work can indirectly influence policy, attitudes, and legislation. Enabling legislation is particularly critical in paving the way for SIBs as it may provide assurance to investors that governments will follow through on their promise to pay for results. The Rockefeller Foundation funded the Center for American Progress to create educational materials and conduct outreach to advance the learning of federal policymakers around the pay-for-success concept. (See page 21 on the Rockefeller Foundation's support of the SIB ecosystem.) Some of our interviewees observed that large, national foundations may have a "comparative advantage" in broad-based research and education programs designed to improve public awareness and support of SIBs. In addition, community foundations may have greater flexibility to undertake advocacy efforts because they are not bound by the restrictions around lobbying that may constrain similar efforts by private foundations.[14]

many foundations are not accustomed to "seeing the world through an investment lens." Thus many foundations may prefer to continue engagement via direct grants to service providers.

ONE FOUNDATION EXECUTIVE ASKED, "ARE SIBS PART OF A LARGER CONVERSATION ABOUT WHAT IT WILL TAKE TO SUSTAIN A SOCIAL SAFETY NET GOING FORWARD?"

OBSTACLES & CONCERNS RELATED TO ENGAGEMENT

Foundations may encounter challenges at each phase of participation in the SIB market. Deciding whether to enter the market, navigating the space, and defining a long-term approach all present obstacles for foundation staff, who must engage in thoughtful dialogue and reflection in order to advance a SIB strategy. Our interviewees noted some of the challenges that may surface in each of these stages.

Weighing Options: Deciding Whether to Engage

Challenge Tradition

SIBs represent a new way to channel resources to the social sector. Foundations, on the other hand, have a long and venerable history—and some of our interviewees commented that such institutions do not change course lightly. By emphasizing investment and performance-based payment, SIBs disrupt the status quo method of financing social services.

Given that grant monies are a valuable and scarce resource, it is hardly surprising that some foundations would hesitate before entering this new and unproven market. Making PRIs in SIBs may be an especially big leap. As one interviewee observed,

Cut through the Hype

Furthermore, some interviewees expressed concern over the "hype." They noted that the media has devoted a great deal of attention to the emerging SIB market in the US, which stands in sharp contrast to the modest number of transactions on the ground. Moreover, a lack of proof points creates a situation in which some onlookers are questioning whether the tool can realize the anticipated benefits. One foundation executive voiced concern that some are rushing into the SIB market without enough data. While he supports investigating the SIB concept, he believes that only a few projects should be fully tested before further activity follows. Another interviewee cautioned against overselling the potential benefits of SIBs. She added that while the use of SIBs to scale proven programs would certainly be beneficial, it may only make a peripheral difference within the social sector, where so many variables affect individuals' lives. Indeed, issues surrounding poverty are multi-dimensional and complex. For example, while SIBs may be aimed at prevention of asthma-related hospital visits, they may not address the deep social ills that result in high rates of asthma among low-income children. And several

14 For further discussion of permissible advocacy activity for foundations, see Council on Foundations, "A Foundation's Guide to Advocacy" (2010), available at http://cof.org/files/Bamboo/programsandservices/publicpolicy/documents/A_Foundations_Guide_to_Advocacy.pdf.

interviewees noted that while SIBs may have the potential to improve some lives, they cannot effect fundamental change in the social infrastructure.

Avoid a Substitution Effect

Some interviewees also cited a concern that if SIBs are funded by grant money that would have gone to service providers anyway, this is merely a substitution—it does not contribute to "growing the pie" of resources for the social sector. To the extent that SIBs eventually attract large amounts of commercial capital, this concern would fade away. (The SIB transaction launched in New York State, described on page 46, provides an early indication of strong interest from mainstream impact investors.)

Along similar lines, some market observers cite worry that enthusiasm for SIBs will drain resources away from foundations' grant budgets and lead them down a slippery slope toward skewed priorities. A proliferation of SIBs may shift resources away from social service programs that are not good candidates for the tool, especially those with a long timeline to success or those with substantial unquantifiable benefits. Since only very specific and relatively few social programs are good candidates for SIBs at this early stage, some foundation staff may be concerned that money will be drawn to those problems and away from complex, long-term challenges.

Some interviewees also voiced concern about another form of substitution effect: SIBs taking attention away from larger, systemic reforms. One foundation executive asked, "Are [SIBs] part of a larger conversation about what it will take to sustain a social safety net going forward?" In his view, SIBs are Band-Aids that could deflect nonprofits and foundations away from broad-based work aimed at grappling with bedrock issues, such as scarcity and donor fatigue.

Overcome Knowledge Gaps

As one of our interviewees noted, there is a great deal of public and media interest in SIBs—but we still need to build deep understanding of this new tool. While many foundation staff whom we interviewed are quite familiar with the concept of social innovation financing, including SIBs, media coverage is not always accurate. For example, the term is often used interchangeably with pay-for-success, yet they have different meanings. (See sidebar on page 11 defining the difference between SIB and PFS.) SIBs are sufficiently complex instruments as to involve a learning curve; one program officer suggested that the threshold of basic understanding required for SIBs is higher compared to other endeavors.

The flexibility of SIBs adds to the confusion, as two SIBs can share a certain set of characteristics but look very different from one another. Moreover, misperceptions are common. One of our interviewees pointed to the misperception that SIBs "let government off the hook." He stressed the importance of conveying that SIBs do not replace government, but rather introduce innovation in the way that government funds social services. Indeed, government is a key partner in the development of SIBs and integral in providing the data underlying a deal's economics.

Foundations entering the SIB market must undergo a learning process that goes beyond a basic understanding of the tool. One foundation director said that before his foundation entered the market, he and his colleagues asked a lot of questions and discussed their concerns internally. They considered the value of an intermediary against its cost, as well as what criteria indicate when SIBs may be appropriate. Another interviewee mentioned the need for learning across the foundation in order to approve a grant for a SIB-related project.

Several others expressed a specific concern about the current terminology, arguing that the term "bond" is distracting at best and misleading at worst, especially in conversations with potential investors. One program officer described this as "releasing an apple into the world and calling it an orange." Another interviewee acknowledged that while "SIBs" may be a misnomer, the term has gained a certain currency at this point. He suggested that focus should shift away from discussion of terminology and toward a more comprehensive market education initiative.

CASE STUDY

Bloomberg Philanthropies: Bringing Commercial Investors to the Table

Bloomberg Philanthropies

When New York City became the first locality in the US to launch a SIB, the risk was too high and the landscape too unknown for commercial investors to become involved without some form of credit enhancement. Bloomberg Philanthropies stepped up, agreeing to guarantee 75 percent of the investor's capital through a $7.2 million grant to MDRC, a social services provider and intermediary that has designed and will oversee the program. The guarantee is structured as an evergreen facility so that if the funds are not utilized in the New York City transaction, MDRC can use them for future SIB deals. Goldman Sachs is the investor in the $9.6 million project, which aims to reduce recidivism among young men exiting the Rikers Island corrections facility. In addition, Bloomberg Philanthropies provided funding for the evaluation and intermediary costs of the transaction through grants to the Vera Institute of Justice and MDRC, respectively.

What attracted Bloomberg Philanthropies to this project? James Anderson, who leads the government innovation portfolio at the foundation, explains that two key factors motivated their participation. First, foundation staff identified the SIB model as one that could be of interest to local governments, which have come under significant and persistent budgetary pressure and are searching for ways to engage the private sector in solving public problems. SIBs align with the foundation's focus on spreading proven and promising ideas among cities. Second, the foundation was interested in using philanthropy to bring in greater support for New York City Mayor Michael R. Bloomberg's Young Men's Initiative, which was launched in 2011 to tackle the broad disparities slowing the advancement of young black and Latino men in the city. By providing a guarantee, the foundation was able to leverage $9.6 million in private dollars from Goldman Sachs, significantly expanding the pool of resources available.

Bloomberg Philanthropies and its partners in this project were well aware of the responsibility of creating the first US SIB, and that they would be setting a "standard that should live up to the promise" of the tool, in Anderson's words. Not surprisingly, the process was long and iterative, but they were determined to get this right and to blaze a path that others could follow. Now that the project is underway, Bloomberg Philanthropies is committed to learning from this SIB, and to sharing this learning with others in the field.

Anderson believes that momentum around SIBs is growing in the US, and he is optimistic about the future course of this market. Now that there are templates and models to follow, he expects that the process should become easier and transaction costs should fall. Providing the guarantee as well as funding intermediation and evaluation costs were critical to attracting private-sector capital to this first deal, he explains, but should become less important as SIBs develop a track record.

Bloomberg Philanthropies focuses on the environment, education, government innovation, and the arts. It distributed approximately $370 million in 2012.

We're In: Crafting & Implementing an Engagement Strategy

Develop a SIB Strategy

Some foundations find the SIB concept appealing, but struggle with issues around how best to support the market and when to get involved. There is significant demand for more resources within the social sector across a variety of issue areas and geographies. Where to target efforts can be challenging for foundation staff surveying the field. Although they want to participate in the SIB market, some foundations are waiting for proof points or a given level of momentum before they commit funds to the space.

Engineer Effective Implementation

The newness of SIBs also creates challenges related to participation in the early stages of a market. Several of our interviewees cited concern with the slow progress and unexpected complexity encountered in developing early SIB transactions in the US market. One staff member at a foundation that has supported an early-stage project commented that the process had not been easy, and that the final project was very different from the initial concept. Another interviewee admitted that they are "struggling" with the challenges of getting projects up and running in a timely fashion—but was quick to add that her concerns are with the abovementioned process issues, not the SIB concept itself.

SEVERAL OF OUR INTERVIEWEES CITED CONCERN WITH THE SLOW PROGRESS AND UNEXPECTED COMPLEXITY ENCOUNTERED IN DEVELOPING EARLY SIB TRANSACTIONS IN THE US MARKET.

Once a foundation has decided to enter the SIB market, staff must decide how to engage: whether to make grants or investments in the market, or support the market through advocacy, partnership development, or policy research and education. With regard to directing capital toward specific transactions, one interviewee stated that SIBs "sit uneasily between grants and investments." Another program officer questioned whether deploying grants would undermine the logic of SIBs, which are intended to produce financial as well as social returns. On the other hand, several foundations observed that SIBs may be too risky at present to qualify for some foundations' PRI portfolios—meaning that grants would be the only option. In the early stages of market development, the lack of a long-term track record for SIBs and poor understanding of risk are barriers to participation through PRIs for some foundations.

To a large extent, the challenge of building a new ecosystem from the ground up is part and parcel of the innovation process. One foundation cited a lack of templates that can be used for pilots, but suggested that as market participants gain experience through on-the-ground SIB projects, the process will become much less complicated. There is also an extra cost associated with being an early player in a new market. Foundations working on these deals emphasized the "importance of getting it right" to create examples that inspire replication.

Related to this point, however, another foundation staff member noted with concern the issue of transparency with regard to progress and outcomes of early SIB deals. Transparency is needed to accelerate the development of the

SIB market so that participants can learn from the successes (and failures) of others. There is no guarantee of transparency at present, however, partly because of privacy concerns as well as some reluctance to share learnings with potential competitors.

Make Collaboration Work across Sectors

The challenge of the collaborative, comprehensive approach is that different stakeholders' interests must be aligned at the start of the project—and remain aligned through the life of the project. As one interviewee pointed out, keeping a diverse group of partners together requires extra effort in "translation." Sometimes the foundation has to use a "different language" in working with communities, such as investors and government, that do not often collaborate.

In this context, a few interviewees expressed a specific concern about the risk of relying on government over a number of years. One underlined the risk that politics might interfere with project execution over time. He added that many of his organization's investors embrace private initiatives to tackle social challenges because of their frustration with the public sector. The passage of enabling legislation for a SIB can mitigate some of the concerns around political risk.

Avoid Unintended Consequences

Some market observers cite a worry that reliance on rigorous outcome targets will create perverse incentives and other unintended consequences. This concern highlights the importance of optimizing the design of the SIB project to avoid sending the wrong signals. A poorly designed program, for example, could incentivize participants to cherry-pick only those participants who are most likely to succeed. Other metrics can lead to poor outcomes for beneficiaries. A reduction in foster care placements, for instance, may lead to keeping children with their families even when they may be better served through other arrangements. (These problems can be avoided through the use of complementary metrics, as well as frequency rather than binary metrics.[15]) Additionally, the fact that payments to SIB investors are based on measurable outcomes raises the concern that a poorly designed SIB project could set up the wrong incentive by measuring only that which is easy to quantify.[16]

The burden that SIBs may place on participating nonprofits and the consequences of failed deals were also topics evoking uncertainty. One foundation executive had reservations about how SIBs might affect the day-to-day operations of service providers. He believed that these projects might place undue strain on the staff at participating organizations. Another executive questioned whether subjecting service providers to higher levels of scrutiny would come at a cost. For example, he wondered whether an organization with a weaker evidence base would replace a service provider that failed to achieve target outcomes.

Overcome Data Challenges

Several of our interviewees mentioned concerns about the quality of data in the social sector, especially for outcomes measurement. In transactions where payments hinge on the evaluation of program outcomes, the quality and quantity of data, they stressed, must be unimpeachable. One interviewee commented that in many cases, service providers and governments lack standardized, high quality data around the effects of service delivery, hampering their ability to participate in SIB-financed programs.[17]

As alluded to above, other market observers are unsure about the effect of measuring and quantifying only the social benefits that are more easily monetized. SIBs' emphasis on rigorous data measurement and evaluation is laudatory, but problematic at the same time. Much of the emphasis on metrics is based on hard costs, which have

15 For further discussion of this concept, see Social Finance Ltd, "Youth Outcomes: A Guide for Service Providers and Commissioners" (October 2012), available at http://www.socialfinance.org.uk/resources/social-finance/payment-results-youth-sector.

16 This is "metric drift" or "metric bias" as described by Georgia Levenson Keohane in Social Entrepreneurship for the 21st Century: Innovation Across the Nonprofit, Private, and Public Sectors (New York: McGraw-Hill, 2012).

17 These concerns are largely addressed in a well-designed SIB. As part of the project development phase, partners pre-determine exactly what data will be required, as well as how to monitor and measure the data. This enables service providers and government to enhance their systems in advance, if needed, to ensure data integrity.

the advantage of being objective and verifiable. But the costs of social ills—and the benefits of overcoming them—may not be wholly quantifiable. There will always be inherent limits to our ability to holistically measure costs and benefits attached to social issues. This may, in turn, raise questions about the ability of the SIB model to wholly capture the benefits associated with SIB-based projects.

Cope with Silos in the Public Sector

The issue of silos as an obstacle to SIB market development emerged as a recurring theme throughout our research. There are two kinds of silos in the public sector:

- *Vertical silos between different levels of government (local, state, national), which distribute costs and benefits unevenly; and*
- *Horizontal silos between government agencies (e.g., health, housing, corrections), which tend to fragment responses to issues that cut across all silos.*

SOCIAL PROBLEMS ARE NOT SILOED BUT MULTIFACETED, SPANNING SECTORS AND LEVELS OF GOVERNMENT ALIKE. THIS MEANS THAT RESPONSES TO THESE PROBLEMS MUST BE EQUALLY MULTIFACETED.

The problem, of course, is that social problems are not siloed but multifaceted, spanning sectors and levels of government alike. This means that responses to these problems must be equally multifaceted—but traditional divisions within government do not support this hybrid approach.

Cope with Silos in Foundations

The philanthropic sector is also somewhat siloed, marked by divisions between program and investment staff that may obstruct progress in developing the SIB market. In particular, these silos complicate the process of funding SIBs through PRIs. Many of our interviewees cited a lack of human capital capacity as an important constraint when it comes to investing in SIBs. Only a small number of foundations make PRIs, and even fewer link their investment and grantmaking staff in any meaningful way. Many foundations are organized around a strict division between giving and investing.

The foundations in our study were almost evenly divided between those that make PRIs and those that do not, making our sample decidedly unrepresentative of US foundations as a whole. Most foundation staff whose organizations make PRIs commented that they would look favorably upon investing in a SIB that furthers their core mission—but then added that there were very few viable deals as yet.

Handing Off: Identifying an Exit Strategy

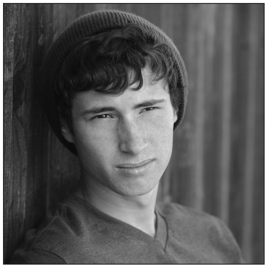
A number of our interviewees were concerned about the heavy participation of philanthropy in early SIB deals, and wondered whether foundations would be able to exit this role in a reasonable timeframe. There was also some uncertainty around the long-term vision for SIBs; would foundations hand off the market to mainstream impact investors, or would government take on the responsibility for scaling up proven interventions? One industry expert noted that, in his view, SIBs are "a mechanism for raising short-term capital to support prevention or intervention programs until public funding fills its place."

Many others, however, focused on the more immediate question of how and when philanthropic grantors would be able to hand off the market to mainstream impact investors. These respondents voiced worry that early, philanthropy-backed deals do not lend themselves to replication or offer an exit strategy for foundations as the market evolves. One interviewee commented, "If foundations are providing very significant guarantees on private investment, then a legitimate question is whether we'll ever get past this initial stage to very clear-eyed investment." Another argued that when a deal provides a substantial guarantee for investors, it may not provide viable proof of the concept; early deals need to be replicable in order to add value to the space.

Some foundation staff worried about the precedent set by guarantees for investors in early deals. They expressed concern that these sweeteners may become embedded in the market and actually obstruct the hoped-for march toward self-sustainability. One foundation staff member voiced concern that the presence of large guarantees makes SIB transactions appear far riskier than they really are.[18]

Others in the market view them as a natural and wholly beneficial factor in developing the market—"training wheels" as one market observer called them.[19] The authors of a 2012 report on the SIB landscape recommend that philanthropy help accelerate the market's growth by providing "subordinated capital, or other credit-enhancement to attract more commercial capital in the early SIB transactions with the goal of reducing philanthropic funding as specific interventions and service providers develop more investable track records."[20]

This debate over the costs and benefits of credit enhancements and other deal subsidies in early SIB transactions is critical to the future of the SIB market; we will return to it later.



A NUMBER OF OUR INTERVIEWEES WERE CONCERNED ABOUT THE HEAVY PARTICIPATION OF PHILANTHROPY IN EARLY SIB DEALS, AND WONDERED WHETHER FOUNDATIONS WOULD BE ABLE TO EXIT THIS ROLE IN A REASONABLE TIMEFRAME.

18 The question of risk assessment in a new market with limited data points—and the difference between perceived and actual risk—is important. For a discussion of risks attached to SIBs, see Social Finance, Inc., "A New Tool for Scaling Impact: How Social Impact Bonds Can Mobilize Private Capital to Advance Social Good" (February 2012), available at http://socialfinanceus.org/sites/socialfinanceus.org/files/small.SocialFinanceWPSingleFINAL_0.pdf.

19 Steven H. Goldberg, "The Social Impact Bond Tribune" (January 2013), available at http://payforsuccess.org/sites/default/files/sib_trib_no._2.pdf.

20 Godeke Consulting, "Building a Healthy & Sustainable Social Impact Bond Market: The Investor Landscape" (2012), available at http://www.rockefellerfoundation.org/blog/building-healthy-sustainable-social.

CASE STUDY

The George Gund Foundation: Pursuing SIBs at the County Level

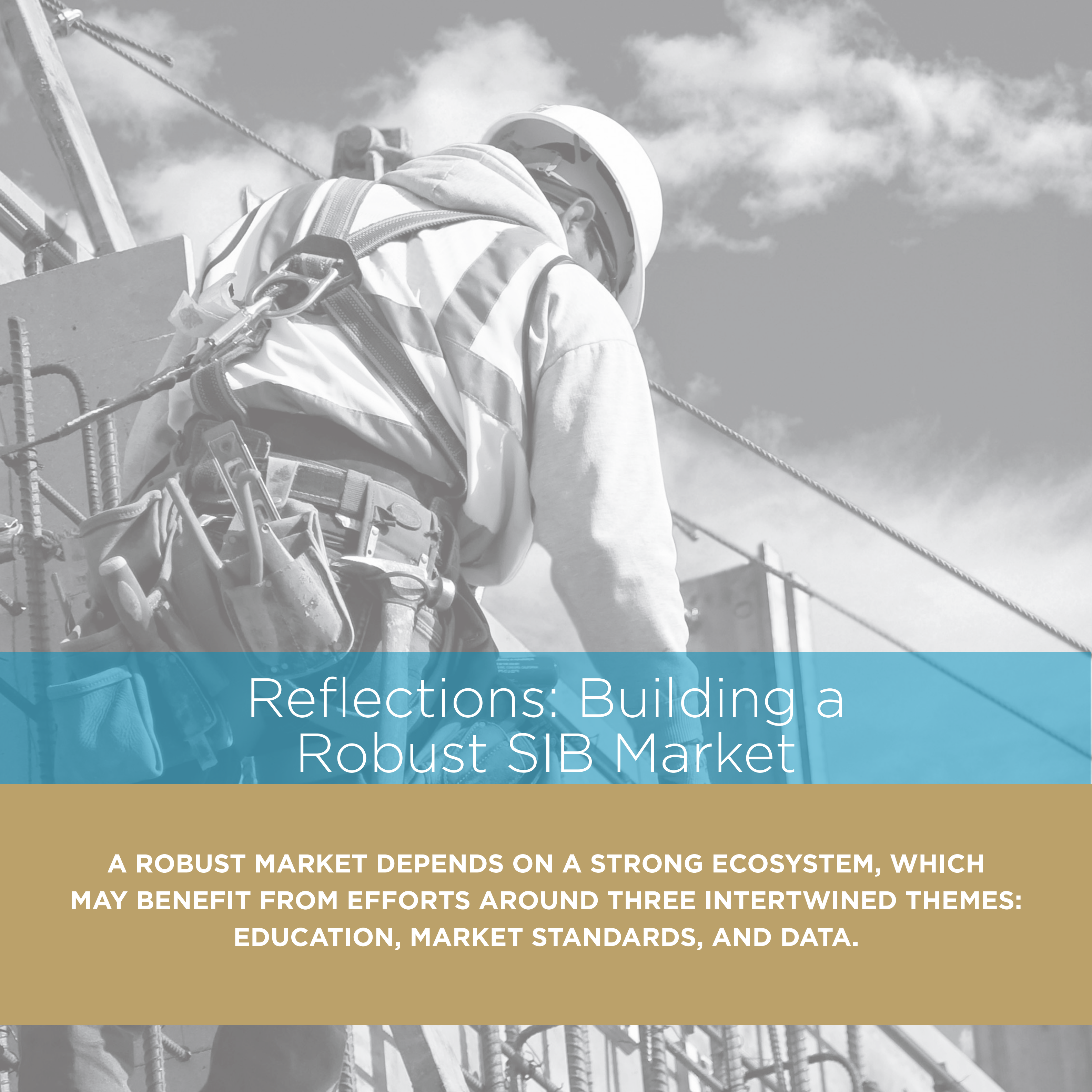
The George Gund Foundation

The George Gund Foundation, based in Cleveland, Ohio, began exploring SIBs when internal research on the tool in 2010 piqued their interest. Since then, the foundation has funded three strands of complementary work in support of a SIB in Cuyahoga County. First, it has made grants to catalyze the SIB development process, including support of an initial exploration of SIB applications, community education efforts, and technical assistance for the county government, which launched a specialized procurement process. Second, it funded work to expand cross-system data analysis capacity within the areas of child protection services, homelessness, and criminal justice, which foundation staff identified as promising SIB applications. Third, it provided funding to support evaluation design and review.

As a direct result of this work, the foundation anticipates that a SIB will be launched in Cuyahoga County in 2014. The foundation has started early-stage exploration of additional potential applications for this financing model, such as possible multi-jurisdiction partnerships with other governments including the State of Ohio through its technical assistance grant from Harvard Kennedy School's SIB Lab.

Although she notes myriad challenges in developing early-stage SIB deals, Marcia Egbert, senior program officer for human services at the George Gund Foundation, characterizes the foundation's experience in this area as "energizing and optimistic." She views SIBs' potential to sharpen focus on what works as a strong source of motivation, commenting "It's exciting to think that we're all in this at the beginning of something that could someday be an established tool to help our most vulnerable citizens." At the same time, she has experienced the challenges of working at the county level, especially in terms of defining public benefits, the complexity of negotiating deal terms when both commercial and philanthropic investors are at the table, and devoting essential senior staff time among all parties. Deeper understanding of the tool's mechanics as well as its limitations, Egbert says, would benefit future development efforts.

Founded in 1952, the George Gund Foundation is a private foundation supporting the arts, economic development and community revitalization, education, environment, and human services in the US. It has approximately $510 million in assets.



Reflections: Building a Robust SIB Market

A ROBUST MARKET DEPENDS ON A STRONG ECOSYSTEM, WHICH MAY BENEFIT FROM EFFORTS AROUND THREE INTERTWINED THEMES: EDUCATION, MARKET STANDARDS, AND DATA.

Thanks to leadership from a number of philanthropic organizations, the evolution of the SIB market has progressed rapidly. Although some participants are frustrated by the long and complex process of launching the first pilots in the US, few other social innovations have advanced so quickly. Their broad appeal among diverse stakeholders has helped to speed the construction of a market infrastructure to support the first pilots. Our interviews indicate, however, that much work remains to be done. At this early stage in the market, data on SIBs' performance and risk are not yet available to attract mainstream impact investors at scale. This means that philanthropic capital will remain in alliance with private investment capital for at least the short term.

Some might wonder why foundations may choose to play a continuing role in the SIB market, helping to enable mainstream impact investors to achieve a financial return on their investment in SIBs. This is a legitimate question, and our response, which was echoed by many of our interviewees, is twofold:

- *First, to the extent that SIBs achieve social benefits that promote the well-being of individuals and families in need as well as society as a whole, a successful SIB is a big win for foundations. It is not a zero-sum game; it is a model in which both foundations and investors can achieve their goals.*

- *Second, foundations can deploy PRIs to invest in SIBs alongside mainstream impact investors and earn the same return. Creating a vibrant SIB market is appealing for foundations looking to broaden their PRI portfolios and over time, may even fit the criteria of foundations making MRIs.*

Our research uncovered several recurring themes related to the continuing role of foundations in the SIB market. How these themes are addressed will determine the future path not only for foundations in this market, but for the market as a whole. The following reflections represent our thoughts, inspired and informed by the foregoing research findings as well as our own deep experience in the market, on how foundations may continue to create a robust SIB space.

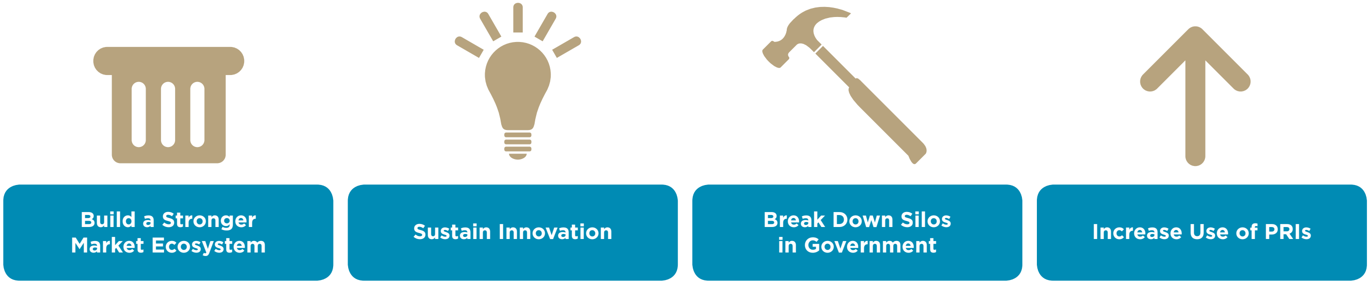


Figure 6. **How foundations can build a robust Social Impact Bond market**

Build a Stronger Market Ecosystem

With the SIB market still in its early days, the pace and quality of future developments will be closely tied to the pace and quality of market-building activity. A robust market depends on a strong ecosystem, which may benefit from efforts around three intertwined themes: education, market standards, and data.

Education

Because SIBs involve many stakeholders and each is critical to the success of the market, a strong knowledge base is essential to promote informed and productive partnerships. The complexity of the tool together with the “hype” and misconceptions around SIBs create challenges that may impede progress. This underlines the urgent need for education in this nascent arena. Market leaders could redouble their work to spearhead a coordinated and comprehensive education initiative aimed at informing government officials, building capacity among service providers, and enhancing the knowledge base of the general public.

Education efforts, which are already underway, could take the form of convenings, media outreach, training programs, and technical assistance to a wide variety of market stakeholders. The emergence of an industry network leader could also greatly facilitate field-building and a wide-ranging education initiative.

Market Standards

There is wide agreement that cohesion around industry standards would streamline the launching of new SIBs and dramatically reduce transaction costs over time. In particular, the industry would benefit enormously from the development of a standard SIB contract template, widely accepted guidelines for selecting service providers, normative outcome measurement methodology, replicable pricing models, and cash-flow schedules. While standardization may be difficult to accomplish across issue areas, efforts to streamline SIB development within a given issue area would enhance efficiency and reduce the time needed to bring deals to market.

As it may take some time and substantial experimentation before the market is able to establish replicable standards, foundations may focus first on encouraging transparency in SIB pilots. Specifically, they can advocate that government officials make SIB contracts and outcomes data available to the public to the extent it is feasible to do so. Foundation leaders can set these expectations for market participants that might be reluctant to share information publicly. By making transparency a key plank in their platform, foundations advocating for SIBs can help stakeholders succeed in learning from the first deals and creating standards over time.

Data

Data are central to the SIB's mechanics. The availability and accessibility of good-quality data provide the basis from which well-structured SIBs can be developed, priced, and launched. Data inform the need for service providers to adjust SIB-financed programming to best serve beneficiaries. Payments to SIB investors hinge on data, as well.

Through grants, convenings, and advocacy, foundations can advance efforts in improving data collection practices, ensuring accessibility in digital format, and expanding policies that facilitate data sharing. Intermediaries may be well placed to assist foundations in this area. Better data on social services would benefit SIB market development, but also aligns well with a broader shift toward better information and informed decision-making. The Office of Management & Budget, for instance, issued a memorandum in 2012 offering federal government agencies incentives for incorporating evidence into their budget requests.[21] Some foundations are already engaged on this issue. For example, the Bill & Melinda Gates Foundation and the William and Flora Hewlett Foundation, along with a for-profit partner, are supporting Markets for Good, a project to improve data in the social sector.[22] Further philanthropic support could accelerate this progress.

Sustain Innovation

Almost all of our interviewees mentioned "innovation" as a major reason for their interest in engaging with SIBs. On digging deeper, however, it turns out that there are two types of "innovation" that motivate foundations. Some are excited by the financial innovation—a new way to bring capital into the social sector to finance proven approaches to social problems. This definition of innovation refers to the financing method, not the social intervention.

Others appear to define innovation more broadly, and are excited about the prospect of using SIBs to test unproven, novel approaches to social problems. Their definition of innovation refers to the social intervention rather than the financing method. This difference may be nuanced, but it matters, especially as we in the industry work to coalesce around a long-term vision.

So what exactly is innovative about SIBs? The notion of investing in projects that can earn both social and financial returns is not new; PRI-makers at foundations and other impact investors have been doing this for decades. Pay-for-success is not an original concept; some government contracts have

ALTHOUGH SOME PARTICIPANTS ARE FRUSTRATED BY THE LONG AND COMPLEX PROCESS OF LAUNCHING THE FIRST PILOTS IN THE US, FEW OTHER SOCIAL INNOVATIONS HAVE ADVANCED SO QUICKLY.

21 Office of Management and Budget, "Memorandum to the Heads of Executive Departments and Agencies" (May 18, 2012), available at http://www.whitehouse.gov/sites/default/files/omb/memoranda/ 2012/m-12-14.pdf.

22 Markets for Good website, http://www.marketsforgood.org/.

long incorporated this feature. And underwriting performance outcomes is a time-tested practice of banks that have issued performance letters of credit,[23] which promise repayment even if the performance outcomes are not reached.

Thus the novelty of SIBs really lies in their ability to bring together a number of models that are already widely accepted in the social and financial sectors. In this sense, the SIB concept is not new; it is a hybrid of old concepts commingled in an innovative way—what Clay Christensen would call a "sustaining innovation."[24] We believe that innovation in the SIB context refers to this hybrid effect rather than to the pioneering of new and untested social services, which should fall within the purview of pure philanthropy. SIBs are an original approach to financing, by bringing financial tools to directly support social services. This philosophy is supported by leadership at a foundation that has been active in the SIB market; Judith Rodin, president of the Rockefeller Foundation, stated recently, "The innovation here is around the financial instrument, not the social delivery organization."[25]

As SIBs advance out of the pilot phase, more innovation likely lies ahead. SIB industry leaders could look for inspiration to models developed in other countries, or complementary concepts in community development finance or international finance to adapt the SIB model to other contexts and issue areas. A more knowledgeable, cohesive market could pursue these innovations even more expeditiously and collaboratively.

Break Down Silos in Government

Foundations may wish to help address the issue of silos within government by incentivizing public-sector actors to work together across traditional dividing lines. The UK's Social Outcomes Fund, for example, creates incentives for governments to pursue SIBs where public benefits cut across various sectors and levels of government. The Fund is intended to supplement outcomes payments for SIBs or other pay-for-success contracts where projects provide substantial benefits but where no single government is able to justify the entire cost. This may be a valuable model for the US. Foundations can bolster this activity through education and advocacy work, as well as grant support like that provided to the Harvard SIB Lab, which works to facilitate government's ability to work across silos more efficaciously.

Increase Use of PRIs

Our interviews suggested that there may be a number of foundations that do not make PRIs at present, but are interested in exploring this option. Those foundations would be well-served by internal capacity-building to break down any silos that may exist between investment and grantmaking operations. It is also essential that foundation boards be educated about the merits of a PRI strategy. Market intermediaries, industry organizations, and foundations with experience in PRIs can all play a role in this capacity-building effort, through a variety of channels.

Foundations that make PRIs may maximize their impact in the SIB market by pursuing several paths simultaneously—deploying grants to catalyze market development, deploying PRIs to help fund SIB-financed projects, and deploying education and advocacy efforts to mobilize public awareness and support. The Big Lottery Fund in the UK, for example, pursued a twin track in supporting the first-ever SIB: providing funds for outcome payments, and providing operating capital for Social Finance UK, the intermediary. Laura and John Arnold Foundation made a grant to a SIB intermediary, Third Sector Capital Partners, and provided philanthropic funding in the Massachusetts and New York State SIB transactions. A hybrid approach that blends traditional foundation activities such as grantmaking with market-based activities may be challenging to implement, but may hold the greatest potential to amplify impact.

23 Like all letters of credit, a performance letter of credit guarantees payment up to a certain amount by the issuing bank; in effect, the bank substitutes its credit for that of its client. A bank issues a performance letter of credit to guarantee that the customer will be paid in the event that the bank's client fails to deliver as agreed under a contract.

24 See Clayton M. Christensen, The Investor's Dilemma: When New Technologies Cause Great Firms to Fail (Cambridge, MA: Harvard Business Review Press, 1997).

25 Paul Solman, "How Modern Finance Promises to Break the Cycle of Recidivism," PBS Newshour (March 14, 2013).

CASE STUDY

Bank of America Charitable Foundation: Contributing Financial Expertise to the SIB Market

Bank of America has been closely tracking the development of Social Impact Bonds (SIBs), or pay-for-success financing options, as innovative ways to provide capital to programs that have a positive social or environmental impact. SIBs are appealing from the company's perspective for their potential to tackle problems facing communities by attracting and unlocking private capital alongside philanthropic and government funding to pursue measurable and cost-effective social outcomes. The bank's involvement with SIBs also stems from increased interest among wealth management clients for investments that can achieve social impact and financial returns.

To advance the SIB market and foster greater understanding of how these new social investments can work, the Bank of America Charitable Foundation provided an operating grant to Social Finance US in 2013. The grant helps Social Finance align the interests of diverse stakeholders, manage inherent risks, and assess whether the nonprofit service providers selected to participate in SIB deals have the capacity to achieve targeted performance benchmarks.

Beyond providing grant support, Bank of America is acting as a convener and an advocate for the SIB market. In the upcoming months, the company is hosting a roundtable to bring together investors and key stakeholders from government, nonprofits, and foundations to discuss the landscape, evolution, and approaches to impact investing. Kerry Sullivan, president of the Bank of America Charitable Foundation, notes, "As a foundation housed within a financial institution, we can provide value to the development of innovative social financing models. We see it as our responsibility to share our expertise with our clients and the general public, and to learn about new ways to invest and address social issues." Sullivan believes that foundation support is particularly critical at this stage of the market to help test and support new models of social-sector financing. In addition to the foundation, Bank of America, U.S. Trust, and Merrill Lynch are together lending their expertise to ensure that deal structures are appealing to investors, replicable, and scalable.

While the SIB market may start with a small number of commercial investors, the bank believes that SIB investment opportunities can appeal to a wide range of investors. Sullivan suggests that this is where the true test lies: if SIBs become viable opportunities for large numbers of individual investors, she notes, we will have succeeded in developing a sustainable market that creates social good.

The Bank of America Charitable Foundation is a corporate foundation that addresses needs vital to the health of communities through a focus on preserving neighborhoods, educating the workforce for 21st century jobs, and addressing critical needs, such as hunger. It is addressing these areas through a ten-year philanthropic goal of $2 billion.

New York State Social Impact Partnership: The First State-Led SIB in the US

In December 2013, Social Finance US, Bank of America Merrill Lynch, and the State of New York announced the launch of the nation's first state-led Social Impact Partnership. Uniquely, it represents the first-ever SIB offering distributed via a leading wealth management platform to private and institutional investors. The $13.5 million in raised funds will be used to expand comprehensive reentry employment services to 2,000 formerly incarcerated individuals in New York City and Rochester, New York.

This transaction sets a standard for measurement and evaluation. It is the first SIB to use a Randomized Control Trial (RCT), widely considered to be the most rigorous evaluation methodology. It ensures that government only pays for outcomes that directly result from the financed program, rather than those influenced by other factors. Moreover, the nonprofit service provider on the project, the Center for Employment Opportunities (CEO), operates an evidence-based intervention and has a culture of data collection and analysis. In 2004, CEO underwent an RCT conducted by a third-party evaluator, which found CEO's services to positively impact its participants. Additionally, CEO uses Salesforce.com, a premier data management system, to monitor participants and inform staff and management decisions. By placing importance on data and evidence, the SIB transaction enhances informed decision-making, government accountability, and taxpayer efficiency.

This pay-for-success partnership brought together the public, financial, and social sectors to achieve common goals—increase employment and improve public safety in New York—and represents a significant step toward a sustainable SIB marketplace. Each partner played an important role in the deal's development:

- ***Social Finance** identified the opportunity, conducted rigorous due diligence to select the provider, brought together the public- and private-sector parties that constitute the partnership, and played a central role in negotiating the transaction. It will provide ongoing performance management throughout the life of the project.*
- ***Bank of America Merrill Lynch (BAML)** distributed this opportunity through its wealth management platform to qualified high net worth and institutional investors via a private placement offering, a first in the SIB space. BAML is committed to transforming the instrument into an investment class that will become a standard component of client portfolios. Altogether, more than 40 investors participated in this transaction, which promises to provide a blend of financial and social returns.*
- ***Center for Employment Opportunities** will receive funding to expand its evidence-based training and employment services program to serve an additional 2,000 recently released inmates over a four-year period.*

AS A RESULT OF PARTICIPATING IN THE TRANSACTION, STAKEHOLDERS ACROSS SECTORS STAND TO BENEFIT SIGNIFICANTLY. MOST IMPORTANTLY, 2,000 INDIVIDUALS WILL RECEIVE THE HELP THEY NEED TO HAVE A CHANCE AT A BETTER LIFE.

- ***Laura and John Arnold Foundation*** *participated in the transaction as a funding partner, underlining its commitment to funding government accountability and evidence-based interventions.*

- ***The Rockefeller Foundation*** *provided a first-loss guarantee to protect up to $1.3 million of investor principal, or approximately 10 percent of the total investment.*

- ***The Robin Hood Foundation,*** *New York City's pioneering poverty-fighting organization, committed early to a $300,000 investment in the transaction.*

- ***Chesapeake Research Associates*** *will independently validate the results of an RCT that measures outcomes for program participants; verified social impact will form the basis of outcome payments to investors.*

Participants in this transaction all agree that the path to completion was sometimes challenging. The deal posed a number of obstacles, including the need to translate between diverse partners with differing priorities and little to no experience of working together. The bank's concern, for example, was to create a mainstream investment product, while CEO was focused on ensuring fidelity to its program model, and the state strived to ensure that taxpayers would only pay for real success. Perhaps most of all, the novelty of the deal was itself a challenge; for both BAML and the state, this was an entirely new way of doing business.

Participants also agree, however, that in the end their ability to accommodate each others' diverging interests laid the groundwork for a much stronger deal. In particular, foundations played a critical role in bringing the transaction to a successful close. The willingness of both the Rockefeller and Robin Hood Foundations to commit to the project in its initial stages was critical. The Rockefeller Foundation signed on early, providing credit enhancement and a strong signal of confidence in the transaction. The Robin Hood Foundation had invested in CEO for over ten years, and brought deep experience in rigorous evaluation. In addition, the Laura and John Arnold Foundation made a major investment, providing a solid anchor for the deal.

"Foundations played a pivotal role in this groundbreaking transaction," says Caitlin Reimers Brumme, director at Social Finance. "The leadership of key foundations, such as the Rockefeller Foundation, the Robin Hood Foundation, and the Laura and John Arnold Foundation, was a vital force in realizing the vision of accessing untapped pools of impact investment capital to more effectively fund services for those in need."

In the early weeks of service delivery, the close collaboration between the state, CEO, and Social Finance is demonstrating an exciting precedent for public-private coordination. As a result of participating in the transaction, stakeholders across sectors stand to benefit significantly. CEO will gain a flexible, predictable source of funding to expand its program; investors will have an opportunity to align their investment portfolio and social values; and government will pay only for positive results. Most importantly, 2,000 individuals will receive the help they need to have a chance at a better life.

The Way Forward

THERE IS A PRESSING NEED FOR SIB MARKET LEADERS TO OFFER A CLEAR BLUEPRINT FOR THE FUTURE. EXACTLY WHAT ROLE WILL SIBS PLAY IN SOLVING SOCIAL CHALLENGES IN THE FUTURE?

Not surprisingly, given the lack of widespread understanding and agreement on basic norms, there is a pressing need for SIB market leaders to offer a clear blueprint for the future. Exactly what role will SIBs play in solving social challenges in the future? How will the market evolve over time? How can foundations support market growth?

Foundations have played a critical and catalytic role to date. However, the patience of foundations is not infinite. Can SIBs throw off the training wheels and become completely reliant upon commercial capital? Or will SIBs continue to involve some form of philanthropic funding? And are there benefits to foundation engagement with SIBs that go well beyond the funds that they bring?

Most of our interviewees expressed the belief that eventually foundations should be able to reduce or eliminate their role as guarantors and grantors in SIB projects; the market should transition toward self-sustainability over time. There is widespread agreement that foundation participation is essential in the early stages of a new and untested tool; there is also widespread agreement that this type of grant and guarantor support should not become an embedded and necessary part of the market going forward. Foundations are now acting as midwives, facilitating the birth of a new market, but their willingness to continue playing this role indefinitely has yet to be determined.

On the other hand, some of our interviewees also expressed doubt about the desirability of SIBs evolving, in the foreseeable future, into tools that are entirely free of philanthropic participation. There is an advantage, they argue, to keeping foundations at the table even as SIBs' appeal to investors grows. Foundations offer a form of social capital or credibility that is respected by other stakeholders, especially those in the government. They supply much more than money; they also contribute long and deep experience with tackling social challenges in new and innovative ways. As noted above, they can promote transparency and data-sharing in a market where information is all-important.

CASE STUDY

The James Irvine Foundation: Catalyzing the Development of the Pay-for-Success Market in California

When the James Irvine Foundation sought to identify a high-impact opportunity to support leaders with innovative ideas that would advance its mission, pay-for-success (PFS) financing quickly came to the forefront. Foundation staff saw that PFS had great momentum in the State of California; initial analysis found over a dozen leaders had initiated work on such projects, but they were often stymied by a lack of resources and proven practices to craft these complex, time-intensive agreements. The PFS model offered the potential to bring new, significant, and reliable resources to proven prevention programs—programs that could expand opportunity for Californians while also reducing costs. The possibility of influencing public policy as well as sharing knowledge gained was also appealing.

To develop an approach to support PFS innovators, the foundation turned to Nonprofit Finance Fund (NFF), which has played a prominent role in SIB market-building work since 2011. PFS would be a special initiative of the foundation, which does not have a dedicated program team to lead the work, so an important condition was the presence of a partner with the capability to implement a program. NFF was well-suited to take on the role of project coordinator. With this critical piece in place, NFF and Irvine launched the California Pay for Success Initiative with an initial grant of $2.5 million in 2014 and the possibility for an additional $1.5 million of funding, should progress be made, in 2015.

The goal of this initiative is to catalyze the development of PFS agreements in California. While there has been tremendous interest by impact investors in this model, few pay-for-success deals exist, and no such deal has tested this concept in California. The initiative will provide up to eight nonprofit and government leaders across the state, selected by NFF, with flexible funding and expert support to help them structure and close PFS agreements. While award decisions will likely prioritize projects that demonstrate the highest likelihood of arriving at signed PFS agreements within two years, projects in earlier stages of development will be eligible as well. The funding can support a variety of project needs, including cost-benefit analysis, data collection, and project management. In addition, the initiative will support peer learning so that project leaders can share and learn from their experiences. Finally, project leaders will have exposure to potential philanthropic investors, with the aim of reducing the time to bring deals to market.

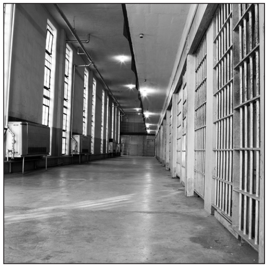
Within two years of the grant awards, the initiative's goal is to have three executed PFS agreements. Don Howard, executive vice president of the James Irvine Foundation, acknowledged that this may be an audacious goal, but stressed the importance of testing the model, which he characterized as being at the intersection of several important innovative forces in the social sector, such as investing in prevention, scaling what works, impact investing, and achieving greater "bang for the buck" for public funding. He also pointed to the potential for multiplier effects. By providing support and learning opportunities to a set of PFS leaders, the initiative is designed to stimulate the creation of a stronger field of technical assistance, knowledge, and demonstration points for future projects. "We believe it's important to build the capacity of PFS leaders so that they can continue to shape this market when the initiative is over," Howard said.

Jessica LaBarbera, director at Nonprofit Finance Fund, expressed enthusiasm for the James Irvine Foundation's groundbreaking approach, and described it as a significant learning opportunity. She characterized the initiative as both an innovative way to think about funding PFS in a space where there is still so much infrastructure to be built, as well as a model for how to deliver resources rapidly and flexibly to support innovation more quickly than traditional grantmaking. PFS, she said, is where the foundation saw an opportunity to use its funding for something that would be "disruptive, scalable, and game-changing." With regard to advancing understanding of PFS, she highlighted the fact that it is still in the proof-of-concept stage. "If we don't see demonstrated progress after two to three years, we'll need to look at that very critically," LaBarbera added. "Valuable lessons may be gleaned that can inform the broader market."

Founded in 1937, the James Irvine Foundation strives to expand opportunity for the people of California to participate in a vibrant, successful and inclusive society. With $1.8 billion in assets, the Foundation made grants of $69 million in 2013.

Others suggest that even if it were desirable to wind down foundation support of the SIB market, this goal is unlikely to be fully achieved for many years to come. Mainstream impact investors may come to contribute perhaps 80 or 90 percent of the capital for future SIB projects, they believe, but there may always be a small but significant role for foundation capital. While philanthropic entities invested £5 million in the first SIB in the UK, future deals could perhaps use the same amount structured as credit enhancement to raise £100 million from mainstream impact investors.

Moreover, since many interventions offer broad social benefits that may be difficult to monetize, it is possible to envision a future in which mainstream impact investors and foundations continue to co-fund some SIB transactions: Mainstream impact investors could fund the bulk of a SIB transaction, which may roughly correlate to the readily quantifiable benefits of the project, while foundations fund a smaller component of the transaction to support the project's difficult-to-quantify social welfare benefits. This arrangement would underline the core strength of the SIB model—its ability to facilitate multi-sector, multi-partner collaboration to generate both social and financial benefits.



FOUNDATIONS SUPPLY MUCH MORE THAN MONEY; THEY ALSO CONTRIBUTE LONG AND DEEP EXPERIENCE WITH TACKLING SOCIAL CHALLENGES IN NEW AND INNOVATIVE WAYS.

As the SIB market learns and innovates from early-stage deals, SIBs will be poised to deliver future benefits as a "sustaining innovation"—technologies that improve the performance of an established product. They are the world's newest hybrid vehicle, created by the merger of existing components and holding meaningful promise for future progress. When Toyota introduced the Prius in 1997, it was the world's first commercially viable gas-electric hybrid car, and it proceeded to revolutionize the industry through its innovative mingling of two distinct power sources. Similarly, SIBs offer the potential to mingle public and private sectors; grantmakers and investors; local, state, and federal government officials; and commercial and philanthropic capital to create hybrid vehicles that are built upon a framework of true and lasting partnership in the pursuit of social progress.

Appendix I

List of Organizations Interviewed

Anonymous foundation

The Annie E. Casey Foundation

Bank of America Charitable Foundation

The Big Lottery Fund (UK)

Bloomberg Philanthropies

The California Endowment

The Clark Foundation

The Cleveland Foundation

The Duke Endowment

The Dunham Fund

The F.B. Heron Foundation

The George Gund Foundation

Global Impact Investing Network

The James Irvine Foundation

The Joyce Foundation

The Kresge Foundation

Laura and John Arnold Foundation

New Profit Inc.

Nonprofit Finance Fund

Omidyar Network

The Pershing Square Foundation

The Piton Foundation

Richard and Susan Smith Family Foundation

Robert Wood Johnson Foundation

The Robin Hood Foundation

The Rockefeller Foundation

Third Sector Capital Partners

The W.K. Kellogg Foundation

Appendix II

Resources on Social Impact Bonds

From the United States

Center for American Progress, Series on Social Impact Bonds. http://www.americanprogress.org/series/social-impact-bonds/view/

Federal Reserve Bank of San Francisco, "Pay for Success Financing," *Community Development Investment Review* (April 2013). http://www.frbsf.org/community-development/publications/community-development-investment-review/2013/april/pay-for-success-financing/

Godeke Consulting, "Building a Healthy & Sustainable Social Impact Bond Market: The Investor Landscape" (December 2012). http://www.rockefellerfoundation.org/blog/building-healthy-sustainable-social

McKinsey & Company, "From Potential to Action: Bringing Social Impact Bonds to the US" (May 2012). http://mckinseyonsociety.com/downloads/reports/Social-Innovation/McKinsey_Social_Impact_Bonds_Report.pdf

Nonprofit Finance Fund, Pay for Success Learning Hub. http://payforsuccess.org

Social Finance, Inc., "A New Tool for Scaling Impact: How Social Impact Bonds Can Mobilize Private Capital to Advance Social Good" (February 2012). http://socialfinanceus.org/sites/socialfinanceus.org/files/small.SocialFinanceWPSingleFINAL_0.pdf

From the United Kingdom

Social Finance Ltd, "A Technical Guide to Developing Social Impact Bonds" (January 2013). http://www.socialfinance.org.uk/resources/social-finance/technical-guide-developing-social-impact-bonds

UK Cabinet Office, Centre for Social Impact Bonds, The Social Impact Bond Knowledge Box. http://data.gov.uk/sib_knowledge_box/

About the Authors

Jane Hughes is the Director of Knowledge Management at Social Finance where she focuses on analyzing industry trends, enhancing organizational learning, and disseminating knowledge to our key audiences. She has inhabited both the financial world and social development world and is dedicated to bringing these forces together for the benefit of all stakeholders. Most recently, Jane was executive director of World Learning's master's degree program in sustainable development in Washington, D.C., where she created and taught a course on microfinance and impact investment. She spent 17 years as an international finance professor at Brandeis University's International Business School.

Prior to her academic career, Jane was a vice president at Manufacturers Hanover Trust Company in New York. Jane has consulted, lectured, and published widely in the fields of international banking and finance; business, government, and the global economy; and international development. She co-wrote a leading textbook on international banking, and is currently working on a second edition of *Separating Fools from Their Money: A History of American Financial Scandals* (first edition, 2007). Jane graduated magna cum laude from Princeton University with a degree in French literature; she also has a master's degree from Johns Hopkins University School of Advanced International Studies, and an MBA from New York University.

Jill Scherer is an Associate Director and Grants Manager for Social Finance where she oversees the organization's foundation deliverables and grant reporting. In addition, she plays a key role in the organization's fundraising efforts by researching and writing grant applications.

Prior to joining Social Finance, Jill conducted research on how innovative finance can drive community and international development. Most recently, she was a Senior Research Analyst with the Milken Institute, an economic and financial think tank in Los Angeles. She co-authored several reports in support of Milken's Financial Innovations Labs, roundtables designed to identify financial solutions to social, economic, and environmental challenges. Her reports spanned the topics of early childhood, health, and small business growth. Previously, she worked in the private sector at Charles River Associates, a business and economic consulting firm. Jill has a Master's Degree in Public Policy from the University of California, Berkeley and a B.A. in Economics from Wesleyan University.

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SOCIAL FINANCE, INC.

Founded in January 2011, Social Finance is a 501(c)(3) nonprofit organization that is dedicated to mobilizing investment capital to drive social progress. We believe that everyone deserves the opportunity to thrive, and that social innovation financing can play a catalytic role in creating these opportunities.

We are dedicated to designing public-private partnerships that tackle complex social challenges, such as crime, unemployment, education, and health. As a market intermediary, we structure these partnerships by aligning the unique interests of all stakeholders—service recipients and providers, government and investors—to create innovative financing solutions. This work reflects our commitment to driving social progress through a market-based approach, as well as our experience in the governmental, capital markets, social services, and philanthropic sectors.

Core to our work is the development of Social Impact Bonds (SIBs), which draw upon private capital to fund effective interventions designed to address the needs of underserved individuals. Social Impact Bonds have the potential to unlock a new and vast pool of investment capital to finance the expansion of prevention-based projects, while focusing on measurable outcomes and generating social and financial returns for investors.

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