



Pay for Success: Financing Research-Informed Practice*

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Undercapitalization of nonprofit organizations and years of seemingly stagnant results in addressing certain social problems have led many to hope that “pay for success (PFS) financing” will bring solutions in the form of new capital to support program delivery, improved accountability, and increased rigor in performance measurement. PFS financing, sometimes termed “social impact bonds (SIBs),” shifts the risk of a preventive social service’s success from taxpayers to investors who finance programs and receive government repayments if, and only if, an agreed-upon performance metric is achieved. Through the use of a third-party evaluator tasked with measuring a program’s success, this new financing strategy encourages research-informed practice that can deliver measurable results. This article explores the structure and potential benefits of PFS financing, as well as assesses challenges and opportunities.

Why Pay for Success?

Many government entities face significant fiscal stress, elevating the critical nature of wise budgetary decision-making. In such challenging fiscal environments, spending for community development activities is often reduced, leaving many organizations and service providers with insufficient capital to meet the needs of their communities.¹ Oftentimes, however, a significant amount of capital is spent remediating issues that might have been avoided had resources for preventive services been available. For example, in fiscal year 2013, 57.2 percent of Philadelphia Prison System (PPS) inmates returned to the PPS within three years of release.² Further, the PPS reported that roughly 63 percent of the daily cost per inmate (estimated at a daily cost of \$20.29)³ is a one-time cost at intake.⁴ Experts cite supportive housing, mental health

and substance abuse services, and workforce reentry as service gaps that are directly related to recidivism.⁵ As the cost figures demonstrate, there is not only a moral case but also an economic case for delivering successful preventive social interventions.

In 2010, a group of stakeholders in the United Kingdom recognized that societal cost savings allow for the monetization of social impact and created a unique financial strategy that has since sparked international interest in rethinking how public funding is administered for social services. Social Finance, a global nonprofit organization with a base in London,⁶ arranged for a group of investors to finance activities that they hoped would reduce recidivism in the Peterborough Prison. A contract was put into place with terms outlining that the United Kingdom Ministry of Justice would repay the investors with interest if the intervention resulted in a reduction in recidivism. Since this project, the first of its kind, was launched in the UK five years ago, interest in this PFS financing has grown and spread internationally.⁷

What Is Pay for Success Financing?

Outcomes-based funding, or performance contracting, is not an innovation in and of itself. In industries such as infrastructure development, service providers often receive government success payments upon the completion of a project. PFS contracting, however, is a recent innovation in public spending approaches in the social service sector. PFS financing, or SIBs, is a financial tool that uses private capital to cover upfront funding for PFS agreements, allowing service providers to implement programs without waiting for the backend payments

* The views expressed here do not necessarily represent the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

¹ Keith Wardrip, *Fiscal Stress in the Small Postindustrial City: Causes, Consequences, and Implications for Community Development*, Special Report, Federal Reserve Bank of Philadelphia, May 2014, available at <https://www.philadelphiafed.org/community-development/fiscalstress>.

² City of Philadelphia, “Five Year Financial and Strategic Plan for Fiscal Years 2015–2019,” available at <http://ow.ly/Qwiyd>.

³ Claire Shubik-Richards, *Philadelphia’s Crowded, Costly Jails: The Search for Safe Solutions*, The Pew Charitable Trusts Philadelphia Research Initiative, 2012, available at <http://ow.ly/PXq52>.

⁴ Anna Fogel, Jeff Shumway, and Anant Udpa, *Roadmap for Pay for Success in Philadelphia*, Social Finance, 2015, available at <http://ow.ly/PXrpy>.

⁵ See Fogel et al., 2015.

⁶ See www.socialfinance.org.uk.

⁷ See <http://ow.ly/QMr1o>.



to occur. The name “social impact bond” may cause some confusion, as “bond” is somewhat of a misnomer. Though some would like to see these instruments grow in availability and sophistication, the securitization of SIBs or the emergence of a secondary market to provide investors with liquidity has not yet occurred. At this point, SIBs function more as a loan to finance government receivables that are paid only if certain social performance metrics are achieved.

PFS financing brings together stakeholders from the public, private, and nonprofit sectors to combat a social issue and achieve agreed-upon goals. Through the SIB structure, a socially minded investor (or investors) finances services and a payer (often the government) is responsible for repayment of the investment contingent upon the demonstration of measurable results. An independent evaluator is responsible for ongoing program evaluation to determine if the repayment trigger is met.

Unlike the current state of most public social service funding, SIBs allow for evidence-based government investment, saving scarce resources by allocating capital based on outcomes, instead of outputs. SIBs appeal to socially oriented investors because they are one of the few products that require as much analytical rigor on the social impact measurement side as on the financial side. If the program yields successful outcomes for the target population relative to a comparison group, as determined by a randomized controlled trial or quasi-experimental study,⁸ investors recoup their principal and can earn a specified rate of return, which may increase along a scale with improved program performance.

Relying on the advice of the old adage, “An ounce of prevention is worth a pound of cure,” most PFS projects focus on preventive services that, if successful, will reduce future public spending on remediation. Although only eight SIBs⁹ have been launched throughout the country to date, promising areas for interventions have emerged, including those aimed at reducing recidivism and homelessness. In these examples, the cost of counseling, supportive housing, or other interventions would reduce future social costs associated with bed days in prison, emergency room visits, and the operation of homeless shelters, among others. Additional intervention areas have been identified, including early childhood education, services for at-risk youth aging out of foster care or juvenile justice systems, and preventive programs and services to address the social determinants of health¹⁰ in low-income areas.

How Do Participants Benefit?

All parties involved in a PFS transaction receive specific benefits from their participation in the project:

Current State of Pay for Success Financing in the United States

Two PFS projects have been financed in both Massachusetts and New York, and additional deals have been financed in Utah, Illinois, Ohio, and California. Though the projects in these locations have received financing, it is too early to determine if repayment triggers will be met.^a One project — the New York City Rikers Island recidivism project — is an exception. The contract included a three-year performance checkpoint, which showed that the program failed to meet the 10 percent targeted decrease in recidivism. As a result, the city did not issue repayments.

In addition to those already mentioned, many additional states and cities are currently conducting feasibility studies and have issued requests for proposals for consultants to assist with PFS implementation.^b The federal government is supporting PFS financing efforts through a variety of opportunities, including grants from the Social Innovation Fund (SIF) at the Corporation for National and Community Service. Additionally, the Workforce Investment Opportunity Act allows local workforce boards to reserve up to 10 percent of their funding for PFS activities,^c and the U.S. Department of Justice’s Second Chance Act includes PFS awards.^d The U.S. Department of Health and Human Services, the U.S. Department of Housing and Urban Development, and the U.S. Department of Education announced that they will soon provide opportunities for PFS grant funding in the near future. Lastly, legislation has been introduced in both the U.S. House and Senate that would create a \$300 million fund at the U.S. Department of the Treasury to support PFS programs at the state and local levels.^e The Commonwealth of Pennsylvania was selected as a SIF subgrantee and is exploring state-level PFS opportunities with technical assistance from Harvard Kennedy School’s Social Impact Bond Lab.^f Additionally, the City of Philadelphia recently conducted a feasibility study of certain interventions that could be supported through PFS programs.^g In New Jersey, a bill supporting the creation of a PFS pilot program and study commission was passed by both houses of the legislature and is awaiting the governor’s signature.^h

^a For more information, visit <http://ow.ly/PXwP9>.

^b For more details on the locations of projects being developed, visit <http://ow.ly/PXwXG>.

^c See <http://ow.ly/QxjVJ>.

^d See <https://www.bja.gov/Funding/12PayforSuccessFAQ.pdf>.

^e See <http://ow.ly/RcjNc>.

^f For more information, visit <http://ow.ly/PXx7o>.

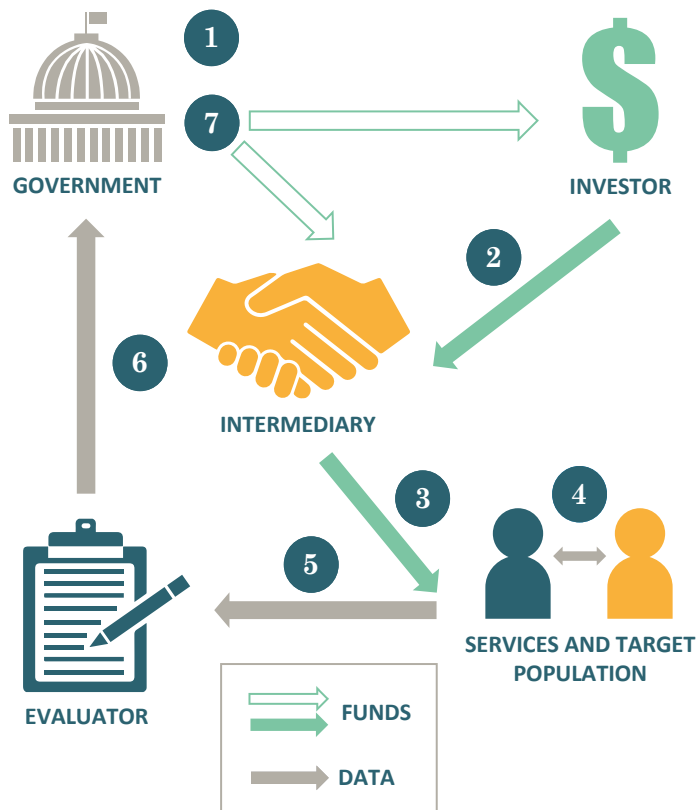
^g Anna Fogel, Jeff Shumway, and Anant Udpa, *Roadmap for Pay for Success in Philadelphia*, Social Finance, 2015, available at <http://ow.ly/PXrpy>.

^h See <http://ow.ly/Qxk5z>.

⁸ Evaluation methodologies differ with each unique SIB. Some stakeholders strongly believe that SIBs require a randomized controlled trial, whereas others believe that alternative methodologies may need to be used for ethical reasons or to allow for smaller sample sizes and reduced evaluation costs. For more information, see George Overholser and Caroline Whistler, “The Real Revolution of Pay for Success: Ending 40 Years of Stagnant Results for Communities,” *Community Development Investment Review*, 9 (2013), pp. 5–11, available at <http://ow.ly/Q0xR8>.

⁹ For more information about the new project in Santa Clara County in California, visit <http://ow.ly/R9AZe>. See <http://ow.ly/QeEN8> for a list of the other seven current projects and some new projects planned for 2015.

¹⁰ For more information on social determinants of health, see World Health Organization resources at www.who.int/social_determinants/en/.



Source: Center for Supportive Housing, *Social Impact Investing: A Tool to Finance Community-Based Supportive Housing and Fulfill the Integration Goals of Olmstead*, 2014

- Government** selects a desired intervention and contracts with all relevant parties.
- Investors** provide the upfront capital to finance the intervention.
- Intermediary** provides the service provider(s) with the working capital to implement the intervention.
- Service providers** deliver services to the **target population**.
- Outcomes and costs are tracked and provided to the third-party **evaluator**.
- The **evaluator** determines whether the agreed-upon metrics have been achieved.
- Government** makes success payments to either the intermediary for distribution or directly to the investors if outcomes are met.

- **Service providers:** Service providers receive a new form of multiyear funding that allows them to focus on program delivery versus fundraising. Although this will be very valuable to some organizations, others will require significant capacity building before they are ready to enter into a complex transaction that requires sophisticated reporting and data collection and sharing.
- **Investors:** SIBs provide a unique opportunity for “impact investors” or investors seeking to receive social as well as financial return.¹¹ By guaranteeing rigorous impact evaluation, SIBs provide investors with a clear understanding of the social impact of their investment.
- **Payers:** The back-end “payer” of a SIB is typically a government entity responsible for repaying the investor when the program successfully meets the impact metric serving as the repayment trigger. SIBs essentially shift the performance risk of a program from taxpayers to investors, and this risk reduction for the payer is a major benefit of the SIB structure.

The payer does not necessarily have to be a government entity. Some SIBs are currently being structured with hospitals, insurance companies, foundations, or other interested stakeholders that receive some sort of value or cost savings from a social intervention serving as the payer.

- **Target Population:** The target population for the program should receive benefits from the SIB in the form of effective service provision through high-quality program implementation. This shift in funding motivates those providing services to become more data-driven and allows for innovation that yields measurable results for people and communities.

What Are the Potential Challenges?

While there has been much discourse around the potential new sources of capital that SIBs may bring to community development efforts and the fiscal savings that will result from the structure, the social services and interventions

¹¹ This is a growing field. A 2015 report (available at <http://ow.ly/SIYgm>) by J.P. Morgan and the Global Impact Investing Network estimates current impact investing assets under management of \$60 billion, an increase of more than 20 percent from 2014. Further, a 2013 report by the World Economic Forum (available at <http://ow.ly/Q0yIq>) projected the impact investing market to reach \$500 billion by 2020.

that are likely candidates for PFS financing are limited by several factors. SIBs require the coordination of many parties, which means that transaction costs can be high and significant capacity commitments are needed throughout the planning and life of the SIB. Planning activities include a thorough cost-benefit analysis and feasibility study of the intended intervention, as well as the coordination of all players on agreed-upon contractual terms, including the length of the investment/intervention term and any necessary checkpoints to assess progress. Ongoing evaluation of the program and a sound process for sharing data are also key components to the success of the project. For these reasons, it has been recommended that interventions requiring an investment of less than \$5 million seek other sources of funding that do not require such complexity in planning, coordination, and implementation.¹² Similarly, interventions that do not generate cost savings or significant outcomes of interest to the payer may not qualify for the additional transaction costs and interest payments necessary for PFS financing.

While PFS financing may effectively allow governments to finance more innovative strategies, it will also require innovation on the part of the government entity serving as the payer. This may require a culture shift and broader system changes. For example, participating in a SIB will require the government payer to be flexible and open to new legal, financial, and data analysis approaches. Additionally, sound policy to support PFS projects is critical. Since programs can last for several administrative terms, appropriations risk could become an issue without legislation or other safeguards in place to ensure that the SIB repayment remains a priority for elected officials. Coordination among different government entities also may be required for a successful PFS project. For example, if societal cost savings accrue across local, state, and federal government agencies, a SIB may require multiple payers and the ability of the intermediary to parse out the unique benefits to each payer during the initial SIB contracting.

Experts agree that the alignment of incentives between all stakeholders involved is critical to the success of a SIB. Since repayment risk is intrinsically linked to successful outcomes, “creaming” of the population (i.e., limiting service provision to those most likely to succeed) to

achieve the intended social outcome has been cited as a common concern.¹³ SIBs should be structured to overcome this concern through the use of intermediaries responsible for ensuring accountability for all aspects of the process. Although broader concerns often have been raised regarding potential conflicts that can arise when private capital is financing public projects,¹⁴ SIBs seem to be uniquely suited to overcome these concerns. Unlike other public-private partnerships, SIBs inherently attract a specific type of investor willing to take some risk in order to achieve social impact. The resulting alignment of priorities with the government entity should help avoid the risk of private investors prioritizing financial motives over public good.

Although the inherent risk associated with SIB contracts could deter some investors, philanthropic partners have provided guarantees, loan loss reserves, or subordinated debt to reduce risk and attract senior investors in the SIBs that have been structured to date. This ongoing support from the philanthropic industry will remain crucial for PFS financing, at least until enough SIBs have been tested to attract a broader investor segment than the current early stage adopters.

Conclusion

PFS financing is a strategy that has attracted interest from public, private, and nonprofit stakeholders around the country eager to find ways to expand the pool of capital available to social service providers while saving limited public resources. Though there is much excitement about this innovation, it is important to note that PFS is not a panacea for the issues that exist in society today. Many problems are structural in nature and may not be solved without broader and deeper systemic changes. SIBs, like any financial instrument, are a morally neutral tool,¹⁵ so deep analysis should be used to determine how and where they are used and the quality of the programs, partners, policies, and processes in place.¹⁶ However, where applicable, PFS financing has the potential to support research-informed practice, generate societal cost savings, and create social impact by improving the lives of vulnerable individuals and communities throughout the country.

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¹² See Fogel et al., 2015.

¹³ Mildred Warner, “Private Finance for Public Good: Social Impact Bonds,” *Journal of Economic Policy Reform*, 16 (2013), pp. 303–319.

¹⁴ See Warner, 2013.

¹⁵ Clara Miller, “Can Social-Impact Bonds Really Have Big Impact?” *Chronicle of Philanthropy*, March 2015.

¹⁶ Eileen Neely and Andy Rachlin, *From the 4 Cs of Credit to the 4 Ps of Pay for Success*. Washington, D.C.: Living Cities, March 2015, available at <http://ow.ly/Q0yTa>.

Additional Resources

- Federal Reserve Bank of San Francisco, *Community Development Investment Review*, 9(1), (2013), available at <http://ow.ly/Q0xR8>.
- Nonprofit Finance Fund’s Pay for Success Learning Hub, available at www.payforsuccess.org.
- Social Innovation Fund at Corporation for National & Community Service, *State of Pay for Success Field: Opportunities, Trends, and Recommendations*, April 2015, available at <http://ow.ly/Q0zt9>.



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