

A GUIDE TO

Evaluating Pay for Success Programs

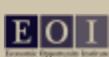
— AND —

Social Impact Bonds

DECEMBER 2015



CO-AUTHORED
BY:



INTRODUCTION

There's no free lunch. Yet across the country, advocates of Pay for Success (PFS), or Social Impact Bonds (SIBs), serve up this alternative private financing model as a cost-free, risk-free silver bullet to support critical, yet underfunded, public services. As local and state governments rush to pass enabling legislation and strike deals with investors, a closer examination of these schemes is warranted.

This guide aims to help advocates identify the critical issues surrounding PFS contracts and their impact on vulnerable individuals and the public. We describe these issues and include a list of key questions advocates can raise to help ensure that decision makers make choices that advance the public good.

WHAT IS PAY FOR SUCCESS?

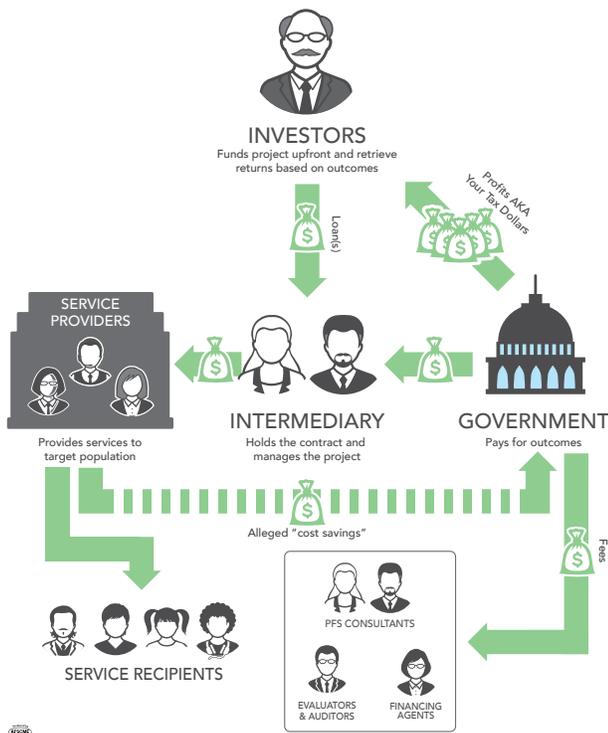
PFS brings venture capital to the provision of public services. Investors provide the up-front funds for critical preventive services with the expectation of receiving a return on their investment. The theory is that the private investment dollars can fill a funding gap when government doesn't have adequate financial resources to spend on prevention activities. Under a PFS arrangement, the government repays the loan with interest if pre-determined social outcome targets are met. The theory presumes that even after paying the investors and service providers, the state ultimately reaps financial savings through foregone budget dollars spent to address future more costly, but now avoided, social problems.

TRADITIONAL DELIVERY OF PUBLIC SERVICES



© 2014
S&B

PFS ARRANGEMENT



© 2014
S&B

PFS contracts are complex. The actors involved include government, an intermediary, an investor(s), a service provider(s) and an independent evaluator, although individual PFS programs may vary in the roles and responsibilities of the parties to the contract. The intermediary manages the money and serves as a project manager. The intermediary also typically hires and manages the service provider. Governments may initiate PFS programs and may have help from the intermediary in attracting investors. Alternatively, governments may receive unsolicited proposals from intermediaries and investors.

In the United States, PFS capital has come from banks including Goldman Sachs, Northern Trust, Bank of America Merrill Lynch, and Santander Bank, as well as high net-worth individuals and philanthropic foundations.

The independent evaluator is responsible for measuring the program’s outcomes and its effect on the target population. Repayment to the investor is triggered when the evaluator confirms that the service has achieved the intended results. Depending on the agreement, if outcomes exceed specified levels, the government may pay investors additional returns. Due to the stakes involved, each party typically must invest in appropriate legal support to develop and monitor a PFS contract.

In the United States, there are eight established PFS contracts, including a program to reduce recidivism among youth detained at Rikers Island that was terminated when projected outcomes were not achieved. As a result of aggressive promotion by intermediaries, boutique firms and consulting agencies, plus pro-PFS policies and funding from the federal government, many more PFS contracts are in the pipeline. Indeed, in 2014, the Corporation for National and Community Service’s Social Innovation Fund launched its Pay for Success program. Through its eight inaugural grantees, 43 programs across the country are receiving PFS technical assistance.² Federal legislation has also been introduced to foster the creation of PFS deals.

Six states, Colorado³, Idaho⁴, Massachusetts⁵, Oklahoma⁶, Texas⁷, and Utah⁸ have passed PFS enabling legislation and more states are expected to follow. Federal legislation has also been introduced to foster the creation of PFS deals.

Images modified from those created by the Canadian Union of Public Employees (CUPE)

WHAT ISSUES DO PFS SCHEMES RAISE?

The theory of PFS looks better on paper than in reality. A closer look at how they operate raises issues that warrant careful consideration for decision-makers looking to undertake a PFS.

MORE COSTLY TO TAXPAYERS



The complexity of PFS entails transaction costs beyond the loan and interest, such as the cost of legal services, evaluation, program administration and loan management. According to McKinsey & Company, “SIBs are a more expensive way to finance the scaling up for preventive programs than if the government simply went to service providers and paid them to expand an intervention to more constituents.”⁹ Cash-strapped state and local governments that feel they cannot fund prevention services directly can be lured by schemes like PFS which do not require cash outlays upfront, even though such schemes are more costly in the long run.

LIMITS THE CONVERSATION ABOUT SOLUTIONS



Often, PFS is pursued to finance prevention programs in areas where the target population faces complex, entrenched problems. Early contracts focused on reducing recidivism, increasing access to pre-K, improving child welfare outcomes, reducing emergency room visits, housing the chronically homeless, increasing access to job training, and reducing teen pregnancy.

Unfortunately, the PFS interventions employed typically do not address the root causes of these social ills. The PFS model, with “a narrow focus on pay for success outcomes and cashable savings, precludes investment in primary prevention” and addressing the underlying structural inequalities.¹⁰ Fixing complex social problems typically requires investments and policy changes on multiple levels.

“ A bias toward programs that produce quick, measurable results narrows the public dialogue and waters down findings. ”

— Donald Cohen, *Executive Director of In the Public Interest*, and
Dr. Jennifer Zelnick, *Touro University*¹¹

For example, the Rikers Island PFS funded moral cognition therapy to reduce recidivism. Options with a potentially larger impact on recidivism reduction, such as decreasing the number of questionable misdemeanor arrests or making access to bail easier, were not considered because they are not amenable to measurement. States have reduced recidivism through other means, including increasing public investment in community-based treatment, re-entry planning and intensive supervision, and providing continuity of care to people with mental health problems.¹² Because these interventions are difficult, if not impossible to measure, these interventions would not be considered in PFS deals. What is driving the PFS solutions conversation is “what can be funded by a PFS deal?” rather than “what structural changes and services can best address the problem we are seeing?”

DIFFICULTY MEASURING OUTCOMES

Measuring outcomes is harder than acknowledged. Governments and stakeholders have to be confident that the measurement tools can demonstrate a direct causal link between the PFS-funded intervention and the outcomes. In other words, PFS contracts have to show that the outcomes are due to the intervention, and not to other external factors.

Establishing cause and effect for a PFS can be subject to dispute. For example, early education experts are questioning the results from a PFS-funded Utah pre-K program in which almost 99 percent of the “at-risk” children avoided special education. Criticism about the rate of success reported by Goldman Sachs, the investor, focused on the apparent over-estimation of the number of kids who were likely to need special education without preschool. Clive Belfield, an economics professor at Queens College in New York, who studies early childhood education states, “Here they seem to have either performed a miracle, or these kids weren’t in line for special education in the first place.” This is a key point since Goldman was paid for each at-risk child who ended up not needing special education after attending pre-K. As Ellen S. Peisner-Feinsberg, a senior scientist at the Frank Porter Graham Child Development Institute states, “You have to be sure you have very rigorous ways to measuring the impact to make sure that it’s legitimate in terms of the outcome you get. That didn’t happen here.”¹³

Unless everything remains the same, isolating the impact of the PFS-funded intervention is not a straightforward exercise. For example, it remains to be seen how evaluators of the Chicago pre-K PFS will adjust for the effects of some low-income children attending a full-day pre-K program, when the PFS is evaluating the efficacy of attending a half-day pre-K program.¹⁴

INVESTORS MINIMIZE THEIR RISK



PFS is a financial novelty, but many of the interventions are not innovative.¹⁵ Investors are risk-averse and seek safe returns. The Government Accountability Office notes that “[i]n practice, investors told us they prefer to back programs that already have a rigorous evidence base because these programs have a known likelihood for success.”¹⁶ Even Goldman Sachs and Bloomberg Philanthropies acknowledged, in their joint statement about the Rikers Island PFS, that the funded approach “had a strong evidence base of successfully reducing recidivism.”¹⁷ Government sponsors should take great care to ensure that they are not compensating PFS investors for risks that the investors are not undertaking.

GOVERNMENT STILL RETAINS RISK



Proponents claim that PFS contracts lower or eliminate risk to the government because the government pays only in the event the outcome targets are met. Field experience shows that this is a misconception. Analysts have found that many investors are uncomfortable with the prospect of being locked into a PFS contract with a long duration. They conclude that future PFS will likely involve more risk sharing – not risk transfer – from government.¹⁸

Officials with the State of Maryland examined the question of whether PFS financing reduces risk to the state and found significant concerns. They found that in the absence of an established PFS market

for high-risk instruments to finance public programs, the state would end up incurring substantial costs in protecting against risk in the course of designing the program, selecting partners and designing contracts. In the event partners cancel a contract, there could be strong political, ethical and administrative reasons for continuing a program. Without an agreement preventing exit, the government could be left responsible for a potentially underfunded or unsuccessful enterprise. It is unknown whether partners would accept such terms.¹⁹

KEY QUESTIONS TO ASK

The questions below identify key issues that should be explored when PFS is being considered. This is not an exhaustive list, but provides a framework for examining PFS deals and enabling legislation.

EXAMINING OPTIONS



- 1 What is the price and performance advantage of the PFS model over traditional financing and performance methods?
2. What is the need or “problem” that a PFS proposal addresses?
What is the desired outcome?
3. Did decision makers consider alternatives to PFS? If there are proven models of social intervention, why structure them as individual PFS contracts rather than broader policy changes?
4. PFS proponents often claim that PFS is the best option to build evidence for interventions and to promote collaboration between government and service providers. Is there a clear explanation for why a PFS is necessary to further these aims?
5. Could a PFS lead to any unintended negative consequences? For example, if the aim of a PFS is to reduce the amount of special education by offering pre-K, could the reduced funding for special education have broader implications?

INTERVENTION SELECTION



1 What is the program’s scale? Is it big enough to provide measurable cost savings to cover the loan amount and interest payments?



2 If PFS is being considered to scale up a program with a proven, evidence-based record of success, why is the PFS structure being used in lieu of traditional public funding?

continued

3. What types of programs will be given priority and consideration? Why?
4. What is the selected program and who is the targeted population?
5. Is the program innovative (i.e., little to no track record of success or evaluation history)?
6. If the program is not innovative, what is its record of success?
7. What are the ethical implications of creating a profit incentive on services for needy, vulnerable and disenfranchised populations? If the intervention is evaluated using a randomized controlled trial, what are the ethical implications of denying access to an intervention that has a proven track record of success?
8. Were outside stakeholders, such as private investors, PFS consultants or intermediaries, involved in determining policy area, intervention selection, and the benchmarks for success? If so, how?

CONTRACT DEVELOPMENT

-  1 Do the investors, consultants, intermediaries, service providers or government officials have any conflicts of interest? What are the investors' backgrounds and track records with these types of deals?
2. Who are the investors?
3. Do the providers, intermediaries and investors have the fiscal capacity to continue program operations through the full-term of the contract?

TERMS OF THE CONTRACT

-  1 What are the specific terms of the contract related to intervention type, delivery, impact to target population, duration of contract, termination clauses, and financial arrangements?*
-  2 Does the contract require annual appropriations by the government into some sort of account, such as a sinking fund, escrow account or special purpose account, during the contract period? If so, does this take funding away from existing programs? And if so, does it still makes sense to engage investors if the state must allocate funds for the intervention in the near term? If a sinking fund is not established, how will the government account for the contingent, unfunded liability?
3. What is the payout to each of the stakeholders if the contract is terminated?
4. Does the government provide a guarantee of minimum revenue to the investors? If so, how will the government make this payment if cashable savings are unrealized?
5. If the investors default on the loan, what guarantees will protect the government?

MEASUREMENT AND EVALUATION

- 1  Are the outcomes appropriate for the program intervention?
- 2  Could there be any external policy or political changes that might impact the outcomes?
 3. How does the contract measure success? What is the evaluation methodology?
 4. What is the threshold or benchmark to trigger re-payment of the loan?
 5. In instances when a PFS is used to scale up a program, how does the threshold compare to the results of previous evaluations of the program?
 6. Do the outcomes lend themselves to manipulation, such as creating disincentives to serve the neediest populations (“creaming” or “cherry picking”), avoiding the treatment of harder-to-help clients (“parking”), creating incentives to skew services to focus on selected outcomes at the expense of other aspects of a program (“tunnel vision”), etc.?
 7. Has attention been paid to data reliability and validity in light of the pressure to produce outcomes? Is there an auditing process?
 8. How much influence do the investors have in determining the desired outcomes and benchmarks of success?

COSTS TO THE GOVERNMENT AND PUBLIC

- 1  What is needed to review and monitor the PFS over the life of the contract? (This should include public sector staff costs.) What is the government’s plan to pay the transaction costs of PFS development, review, and monitoring? What is the government’s plan to pay back the loan?
- 2  How are the alleged cashable budget savings supposed to be realized, measured, and captured? Is there a clear link between the PFS program and the costs avoided within a specific time frame due to improved social outcomes?
- 3  If the program is successful, how will the government fund and staff it beyond the PFS contract period? If it is currently outsourced, will it remain outsourced or will it be insourced?
 4. Did the government compare the cost of operating the program in-house, through a direct contract, as well as through the PFS process? This comparison should include a description of all stakeholders, financial terms and the costs to the government of development, monitoring, performance measurement and auditing.

continued

5. What is the return to the investor(s)? How is it calculated?
6. How does the PFS return compare to the interest rate governments pay on comparable short-term operating debt?
7. What resources are the state and local government putting into developing the PFS? (This should include public sector staff costs.)
8. What are the minimum and maximum loan repayment amounts?
9. If the PFS is being used to expand an existing program, how does the government currently capture the cost savings?
10. What impact will the PFS have on the public sector workforce?

SERVICE DELIVERY



- 1** How will the government ensure the service delivery aims for quality service, and not just on producing the desired outcomes?
2. What influence will investors have over service delivery?
3. Is there a minimum level and type of service that all eligible participants will receive?
4. What are the wages and benefits of the service provider staff?

ENSURING TRANSPARENCY AND ACCOUNTABILITY



- 1** Can the public provide input about the outcome selection and design? How are the outcomes designed and determined?
2. Who are each of the proposed stakeholders?
3. What rights does the public and the legislative body have to see documents between government and other entities related to the PFS, especially before it is finalized?
4. Given that the PFS contracts are to be paid back with public funds, will open records laws apply to the documents between the other parties to the agreement, like among the intermediary, investors, and service providers?
5. How can the public influence the delivery of the PFS service?
6. Will the government retain oversight and scrutiny of the PFS?

continued

GOVERNMENT CAPACITY AND EXPERTISE

- 1  Does the government have experienced staff to negotiate the best deal for the public?
- 2  Does the government have in-house staffing and expertise to adequately monitor the PFS to its conclusion?

ENDNOTES

- 1 Pay for Success (PFS) and Social Impact Bonds (SIB) are similar financing structures. Since the term Pay for Success is used widely in the United States, we use this term and PFS, except where quoting others using SIB.
- 2 [List of grantees, subgrantees, and subrecipients](#) listed on the Corporation for National & Community Service site.
- 3 [HB 15-1317](#). Approved 2015.
- 4 [H0170](#). Approved April 2015.
- 5 [An Act Establishing the Social Innovation Financing Trust Fund](#). Approved 2012.
- 6 [SB 1278](#). Approved 2014.
- 7 [HB 3015](#). Approved 2015.
- 8 [HB 96](#). Approved 2014.
- 9 [From Potential to Action: Bringing Social Impact Bonds to the US](#). McKinsey & Company. May 2012.
- 10 [Social Impact Bonds in Criminal Justice: A Deal We Can't Refuse?](#) August 2015. Prison Legal News.
- 11 [What We Learned from the Failure of the Rikers Island Social Impact Bond](#). August 2015. Donald Cohen and Jennifer Zelnick.
- 12 [Alternative to private finance of the welfare state: A global analysis of social impact bond, pay-for-success and development impact bond projects](#). 2015. Dexter Whitfield.
- 13 [Success Metrics Questioned in School Program Funded by Goldman](#). November 2015. *The New York Times*.
- 14 [Emanuel's preschool expansion facing enrollment woes](#). March 2015. Catalyst Chicago.
- 15 There is considerable debate about whether PFS are all that new. For example, Clara Miller writes that: "One way to remove the rouge of innovation from the wizened face of this financial instrument is to refer to them as "performance contracts." Versions of pay for success have been used in many states for years. For example, there is some similarity to the shared energy savings contracts of the 70s and 80s, where a company fronted the capital cost of energy-saving equipment (i.e. florescent lighting, a new boiler or timer switches) in a building at no upfront cost to the owner, then split the subsequent "savings" (i.e. the monetized value of the reduction in energy costs) with the owner until the original investment, plus a return, was realized." From: [Social Impact Bonds' Slippery Slope](#). May 2015. *Huffington Post*.
- 16 [Pay for Success: Collaboration Among Federal Agencies Would Be Helpful as Governments Explore New Financing Mechanisms](#). September 2015. Government Accountability Office.
- 17 [What We Learned from the Nation's First Social Impact Bond](#). July 2015. *Huffington Post*.
- 18 [Building a Healthy & Sustainable Social Impact Bond Market: The Investor Landscape](#). December 2012. Godeke Consulting.
- 19 [Evaluating Social Impact Bonds as a New Reentry Financing Mechanism: A Case Study on Reentry Programming in Maryland](#). January 2013. Department of Legislative Services, Office of Policy Analysis.