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Centre for Local Economic Strategies

bulletin

# 'New' models of social finance

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**Overview**

This Bulletin follows on from CLES Bulletin 85 – '*Financing economic development in a cold climate'* – which focused on new ways of working and sources of finance for economic development. It takes a look at some of the challenges and potential solutions which different places have used to deliver sources of finance for social benefit; and provides some of CLES' thoughts and recommendations. We particularly look at social impact bonds and prudential borrowing.

**Background**

There is a rising interest in different sources of finance to address social issues. A combination of cuts to government funding, as well as the failure of neo-liberalism to address structural problems - such as poverty and social exclusion, and environmental degradation - has led many governments to look closely at civil society initiatives and 'new' sources of finance to address these difficulties.

There is also a growing recognition that effective interventions can bring significant economic benefit, as well as creating significant savings for the government purse and society.[1] The Conservative Party green paper Control Shift: Returning Power to Local Communities, released by David Cameron in 2009, provides an insight into the current Governments direction of travel.

One section of Control Shift explicitly tackles the issue of capital financing in local authorities, arguing for the creation of local authority bonds as a major new financial innovation for local authority capital project:

*"We are currently looking at ways to allow local authorities to promote and market local bonds to deliver privately-financed local projects, such as a new transport service or business development…These bonds would be secured against the projected income stream associated with a specific project. They would explicitly not be backed by direct local authority liability, but instead would be issued in the name of a commercial or third-sector operator on behalf of a project."*[2]

The need for financial innovation clearly must complement the traditional sources of funding for social enterprises, which includes: government direct grants and subsidies; sources of finance through philanthropy; financial institutions including conventional banks, credit unions, financial cooperatives and mutual societies; contracted service delivery and individual investors. Whilst there is an embryonic market providing some of this social investment capital in the UK, much more could be done by both central and local government in stimulating access to finance in support of both local economic and social benefit.

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[1] Barclays & New Philanthropy Capital (2011): Barclays Wealth Early Interventions: An Economic Approach to Charitable Giving
[2] Control Shift: Returning Power to Local Communities, Policy Green Paper no. 9, conservatives.com

## Introduction to social investment

The investment market has transformed considerably in recent years. The emergence of social entrepreneurs, new financial instruments, and public policy are just some of the components driving change in the social venture market. New actors are emerging, and old actors are transforming their roles from donors to investors; and supporting growth in new 'venture philanthro-capital'.[3]

Social ventures deliver considerable benefits to communities around the UK.[4] However, in the light of the current economy and business climate, access to business support and finance has become more challenging. In order for social ventures to succeed in addressing the challenges we face, on a scale that will make a sustainable difference to the UK, they need to be able to access investment capital and advice in an appropriate form and at the right time.

To achieve these aims on a grand scale, the UK needs a functioning, large-scale social investment market. Here, government (at all levels) can help to deal with some of the barriers that might beset the successful roll-out of social finance, including: building appetite and ability to manage investment risks; supporting the development of evaluation of success (the best way of reducing the risk to impact); and providing support to accelerate the learning curve associated with social innovation - by providing the flexibility for experimentation and risk-taking.

However, to be successful government needs to undertake significant re-visioning of their measures of success (i.e. short vs. long-term impact horizons). Social enterprises must be recognised for their capacity to create socially inclusive wealth by all potential funders, although the ways in which this contribution is measured will differ based on the type of return sought by the financing organisation (market returns, below-market returns, for example).

Therefore, the issue of financing social enterprises is not to be addressed from an isolated perspective that focuses on financial transactions between purely lenders and borrowers (or recipients), but in the context of an integrated systemic approach including a greater collaboration between financiers, private and public centres of knowledge, local policy makers, and community organisations, to develop new sources of capital to address joint social priorities.

### *Barriers to investment*

Investment in social enterprise has been hampered by the fact that they are perceived as less attractive to potential investors because there is, as yet, no widely recognised and accepted means of quantifying and benchmarking Social Return on Investment (SROI).[5] Support to mitigate some of these challenges typically includes:

- the development of full economic costing – so organisations can clearly and accurately understand their cost base and therefore asses a realistic scale of finance to access;
- the development of transparent accounts and accounting processes – so that investors can appreciate the sources and uses of money;
- the training and development of risk averse board members – so that they are aware of the true level of individual risks attached to securing loans;
- the development of more consistent approaches to measuring Costs and Benefits;
- realistic views and analysis of Returns on Investment and payback timescales.

[3] Bishop M; Green M. (2009): Philanthrocapitalism: How the Rich Can Save the World
[4] NESTA (2010): Twenty catalytic investments to grow the social investment market
[5] Many commentators critique a lack of consistency in approach, and therefore ability to benchmark returns

## Social Impact Bonds

### *Overview*

Social Impact Bonds (SIBs) are a mechanism to reward non-government investors that fund early-stage interventions to improve social problems, which if successful, deliver both social value and public sector savings.[6] They allow closer government co-operation with the private and social sectors in order to improve service provision and alleviate social problems.

The bonds act as a vehicle for private investment to be used for social programmes, which can either be directly provided by government agencies, or by third sector organisations. This has the advantages of:

- bringing in investment which otherwise would not be available;
- reducing uncertainty of funding for social projects;
- the potential to forge innovative partnerships to address issues.

SIBs have been used in America, and Australia for some time. They are a financial vehicle which is significantly different from the ways governments currently fund and tackle social problems. Rather than providing single up-front funding, a public sector organisation agrees to pay the contractor for outcomes that will be delivered over a period of time, rather than a single year. On the basis of this contract, investment is raised from socially-motivated investors who are interested in financial returns and social outcomes.

### *Structure and implementation*

SIBs are typically structured around a set of well-defined outcomes between the three main parties involved, i.e. government, the service provider and investors. This relationship can be brokered by an intermediary, on behalf of the wider group. Bonds offer a fixed return to investors over a period of time, acting more like an equity product in terms of associated risks (and rewards).

The contract between government and the investor forms the terms of the bond and agreement is made on a specific beneficiary that needs to be helped, impact measures; and on how much return the investment will accrue if the project is successful. Generally, any agreement will state that the more successful the programme, the greater return the investor will accrue.

When the agreed time period has expired, the government pays investors back their return; and savings on service spending can also be used to pay back investors. The investment may also be used to fund or expand organisations with the expertise to manage the programme of support. Therefore reliable sources of funding should foster an innovative and creative environment and enable service providers to explore new project pilots. This is particularly important and allows government (at all levels) to continue to fund innovative social programmes despite considerable budget cuts.

### *Evaluation and return on investment*

SIBs could help to create an 'evidence incentive', by making the effective measurement of social impacts more valuable to projects. Investors will be looking for 'demonstrated value', efficiencies and cost savings to satisfy an interventions endorsement. In creating an incentive to invest only in the most effective projects, SIBs should also encourage the development of best practice and the use of quality evaluation processes and outputs.

It will be important for all those involved with SIBs to evaluate the inputs, outputs and outcomes from interventions; and to compile a data-bank of practice, value for money and return on investment. Over time there is potential for growing consumer interest in SIB investment, for example by making

[6] Social Finance (2010): Towards a new social economy

potential investment choices available within a pension portfolio and choosing a certain proportion of investments with a social and financial return.[7]

### *Potential stakeholders*

Governments have a role in providing early incentives to help encourage participation by a variety of stakeholders, using funding to 'pump prime' activity, as well as helping to source and leverage finance from additional public and private sources. They can also be part of the machinery by which SIB investments are held accountable, to both investors as well as the wider local community; and to support the establishment of monitoring and evaluation processes that will measure progress against objectives and targets for support.

Support foundations (private, social and corporate sponsors) could be engaged in supporting relevant investment themes, as well as providing input into scheme design and early 'seed' finance to help encourage pilot testing and evaluation to inform wider programme design. As such, bonds also have the potential to change the role of government in the provision of services, by helping to define social priorities; and to test-bed new ideas for addressing intractable social challenges.

Whilst the most frequently cited example in the UK is the Peterborough SIB model (see case example), there is a growing belief that the reach of the model is much wider than the field of Criminal Justice. Some of the potential areas which SIBs could address include: elderly-care, youth employment, housing for at risk groups, re-offending and integration, early years, and healthcare interventions.

### *CLES' thoughts*

**The promise of the concepts underpinning the model are creating wider appeal.** National and Local Government have an important role in the implementation of SIBs. They can provide a focus for researching, advising and helping to set priorities for action in a local area. This includes encouraging discussion and collaboration, providing greater access for service providers to their target population; and encouraging cross-sector partnership covering different public and social service areas.

**There needs to be clear demonstration of the link between the support/intervention and the improvement in social outcomes.** For many services, for example those being developed for the NHS, this is a fairly easy task. Many new healthcare services provide an outcome that improves people's health in a measurable way, and within a timeframe that permits the recording of progress and impact. However **some potential investments, such as early years and childcare interventions, have many years until outcomes are realised**. Several intervening factors could make it difficult to attribute long-term impacts to the initial investment.

**Baseline evidence, ongoing monitoring, formative and summative evaluation are critical for evidencing the relationship between intervention and outcomes**; and for identifying the extent to which new models of support displace, or negatively impact upon, the uptake of services. This requires an accounting system that tracks investment and savings, as well as the ability to monetise all costs and benefits associated with a project. However, this is not always a straightforward calculation, for example assessing the value of changing beneficiary's confidence, motivation, and general well-being. Again, **experience and the compilation of evidence from other similar local and national studies will prove beneficial**.

**Once an investment vehicle has an established track record, i.e. has more information about long-term impacts and returns, it could become a new social asset class**. However, funders and investors increasingly want to understand the impact of their contribution. Non-profits and social enterprise are challenged within their current funding regimes and performance management frameworks to satisfy these demands. Though numerous initiatives have developed social and environmental performance metrics, methodologies are fragmented and sector impact measurement remains largely inefficient and expensive.

[7] The European Investment Bank has chosen a consortium which consists of The Association of Greater Manchester Authorities (AGMA), CB Richard Ellis and the Greater Manchester Pension Fund as preferred bidder to deliver proposals for a Northwest Evergreen Fund. The unique fund will start with £20m in public money allocated from the Northwest's share of the European Regional Development Fund as part of its JESSICA (Joint European Support for Sustainable Investment in City Areas) scheme.

**Standards, similar to those adopted in financial accounting, are needed to enable performance reporting, comparison, and benchmarking.** Performance reporting has reflective and future planning implications; advancement in this area will improve organisational efficiency and productivity, but will also attract new sources of capital.

**Other potential political risks exist.** SIBs could be viewed as the government off-loading responsibility for social services, only stepping in when the market fails rather than creating a wider public or social good. Taken in the extreme, this could also be perceived as government being more concerned about investor capital and benefits, rather than delivering wider public value/benefit. SIBs therefore require careful design and implementation, as well as accompanying **communication plans to ensure that all stakeholders (across public, private and social sectors) are bought into the investment and what it is trying to achieve**.

***Case example: St. Giles Trust and supporting ex-offendors***

The first SIB was launched in September 2010 by Social Finance to reduce re-offending levels. The rehabilitation of offenders is a cornerstone of the Government's criminal justice policy. Successful rehabilitation will deliver benefits to society and reduce public spending on the prison system. Fewer offenders will commit less crime requiring fewer prisons, costing less money.

Re-offending costs the state a minimum of £143,000 per offender, per year (excluding the wider costs to the victims of the crime). It is estimated that nearly two-thirds of adults on short-term sentences will re-offend within a year of release, costing taxpayers at least £86m/1,000 prisoners.

However, St. Giles Trust, an organisation working to reduce crime and exclusion has proven that its approach of counselling, re-training, guided employment services and aftercare, reduces re-offending rates by at least 10 percent; and successfully re-introduces ex-offenders back into the community. The pilot is providing support to 3,000 short-term prisoners over a six year period.

The up-front investment includes up to £5m from private investors (i.e. Esmee Fairbairn Foundation, the Monument Trust and several charitable organisations) who stand to receive a share of the long-term savings made by Government, up to 13% return on investment, should re-offending be reduced by 7.5% or more. In terms of cost/benefit ratio, every £1 invested in the Trust, saves the state £10.

Another critical factor for the investment is that it helps to overcome the natural time-lag between offering new and improved rehabilitation services, reducing re-offending and closing prisons. With no new public funding available for rehabilitation services, particularly in the current spending environment, leaves little choice on how else such a transformation can be funded.

## Sources of prudential borrowing and 'revolving funds'

### *Overview*

Local authorities are facing a 'triple wammy' of pressures on the investment and funding of services. The difficult settlement in the Government's Comprehensive Spending Review (2007), combined with the severe rounds of cuts to spending (and employment) have - with rising levels of unemployment - put tremendous pressure on services and critical infrastructure. Indeed many public development projects have stalled.

However, recent studies[8] have provided excellent examples of how Local Authorities (and their local partners) have used prudential borrowing to support the development of 'revolving funds'. This has allowed organisations to focus on what they want to achieve within their local area and to continue with projects which stalled during the recession, rather than being restricted to what is only available in existing capital and revenue accounts.

[8] APSE (2010): The virtuous green circle: creating a revolving fund for local authority solar energy

The Local Government Act 2003 introduced three key new freedoms and flexibilities for local authorities including the Prudential Capital System. The use of prudential borrowing has helped organisations to kick start schemes, at the same time smooth out capital programmes and free-up revenue. The key borrowing requirements must take account of the two main objectives of the Prudential Code, which are:

- that capital expenditure plans are affordable;
- all external borrowing and long-term liabilities are within prudent and sustainable limits.

Other 'good practice' includes the implementation of self-regulation by adherence to recognised codes of practice (e.g. Chartered Institute of Accountants); and the use of financial modelling, monitoring and key indicators, as part of an annual investment strategy that shows how an authority is demonstrating 'prudent' borrowing.

***Developing a 'revolving' fund***

A revolving fund is a legal vehicle, typically governed by shareholders and members from a local community, or by a Local Authority that has raised money through, for example, Prudential Borrowing and the Public Works Loans Board (PWLB). This is one of the main sources of finance for local authorities, providing low interest rates which are highly attractive for local authorities in search of funds for capital expenditure. PWLB is a statutory body that operates within the UK Debt Management Office, which is an Executive Agency of HM Treasury.

In general local authorities can borrow at a lower rate than those charged by the banks. This is because they have a very high 'credit worthiness'. Rates of interest have also fallen significantly since the 2007 financial crisis; and PWLB still offers one of the most viable and cheapest forms of finance for capital projects.

A number of Councils around the country have used PWLB, and other sources of finance, to support the initiation and development of revolving funds. Many of these are linked to schemes to address commitments to carbon emissions reductions; and reflects a growing recognition of the financial value of support for energy and resource reductions as well as meeting sustainability goals.

Pioneering communities around the UK are also using revolving funds to finance community projects, such as micro-generation projects which cut carbon emissions and benefit local people. The essence of a revolving fund is that the initial investment is repaid on a steady, predictable basis; and frees up cash to invest in further (e.g. carbon reduction) schemes. By reinvesting returns, or spending them for example on other carbon saving projects, communities have been able to multiply the impact of investment and avoid the need for continual injections of grant funding.

In our case study (see box below), a revolving fund was set up by a local authority raising the money for a scheme and depositing an amount of capital into a specific project account to finance a solar panel scheme that will generate a guaranteed revenue over 25 years. The project is procured, delivered, and as it progresses, the benefits increase and the Council earns revenue – in the case study from the electricity generated by the scheme through the Feed-in-Tariff.

***Revolving funds for economic, social and environmental benefit***

Government policy has created a new revenue stream for low-carbon energy projects that make it easier for local authorities and communities to make a fund 'revolve'. For electricity generation projects, these work by paying the 'generator' a fixed Feed-in-Tariff (FiT) for each unit of electricity produced. The tariff varies between solar, wind, hydro and other technologies and also according to the size and scale of the installation. The aim of these FiTs is to ensure that projects return 5-10% of their upfront costs every year.

After a given period of time, the host organisation will also have repaid the start-up loan entirely and so has the choice of taking out a new loan to increase its scale, or reinvesting the money it was previously re-paying on the loan in other services. The initiative also aims to create a spirit of individual and collective ownership and pride in becoming a low-carbon community. This can lead to positive impacts beyond the immediate energy project's financial returns.

Other well documented national funding includes the Revolving Green Fund (RGF). This is a partnership fund between HEFCE and Salix Finance Ltd that aims to help higher education institutions (HEIs) in England reduce greenhouse emissions. £30 million was made available from 2008 to 2011 to provide recoverable grants to institutions for projects that reduce their emissions. Institutions repay the funds through the savings they make to emissions.

The fund has two strands, an institutional small projects (ISP) fund which allows the incremental implementation of small scale projects over time; and a 'transformational' fund for large, one-off projects which significantly reduce emissions. Interim evaluation highlights that the fund is successfully working towards meeting its stated aims by providing a major mechanism for institutions to invest in this area, accelerating carbon reduction with current projects saving over 2% of English HEI carbon emissions every year.

### *CLES' thoughts*

**The key task for project managers is to manage the 'trade-off' between capital expenditure and revenue; and to ensure that long-term liabilities are within prudent and sustainable limits.** With the right leadership, support from Chief Officers and Leaders, proper planning and careful business planning and the management of risk, revolving funds can be a significant source of revenue for Councils, commercial services, community groups and residents.

CLES' recent work for the Association of Public Service Excellence (forthcoming) highlights through economic analysis and case studies that there is significant opportunity to stimulate both revenues and growth in employment through 'revolving' investment to promote the local production of energy from renewable sources. LAs can establish a virtuous circle of investment that will benefit local economies and the environment, both now and for future generations.

**There is significant potential for local authorities to use prudential borrowing to support local economic benefit and employment.** All 'revolving' investments delivered by local authorities using prudential borrowing are self financing, in that the cost of borrowing and repayment is met by revenues gained through the investment. In many cases these are helping LAs to extend existing infrastructure and service user levels.

Such improvements can also create new jobs in a local area, (in particular where the LA used procurement to help 'lock-in' local economic benefit) both in the short term through work to create or improve a service and then the longer term provision of the service. The overall gains of service improvement, financial control, and in many cases environmental improvements outweigh the costs associated with borrowing.

Important lessons have been identified from the management of 'revolving investments' **including the use of designated officers to support the fund** and act as an advocate for the project proposals with both Council Members and help to **ensure that community representatives with a stake in the scheme are included in its design and delivery**.

Projects must also be thoroughly reviewed and carefully implemented, especially in the stages of calculating performance and cost savings; and **evaluation processes must be implemented from the beginning** to assess all impacts and savings associated with specific projects.

**For some organisations the transition to equity capital (and debt finance) will be too great a leap, and initiatives should continue to be developed with financial products that bridge the gap between grants and loans.** Examples such as the Communitybuilders Fund, previously owned by the Department of Community and Local Government and now an endowed fund, owned and administered by the Adventure Capital Fund, supports neighbourhood-based, community-led organisations to become more sustainable through a mixture of loans, grants and business support.

Likewise, social finance intermediaries and trusts such as Bridges Ventures[9] are initiatives that tailor each investment to ensure that it fits the needs of each particular social enterprise; and leveraging contact networks of private equity companies to support Bridge's social objectives.

***Case example: Warrington Council and Golden Gates Housing tackling fuel poverty***

Warrington Borough Council are using prudential borrowing to work in partnership with a local housing trust (Golden Gates) to install solar photovoltaic panels on 600 properties owned in some of the most disadvantaged neighbourhoods; and help to take some residents out of 'fuel poverty' from savings on electricity bills. The Council have made a significant commitment to addressing climate change by signing the Nottingham Declaration; pledging a commitment to meeting the Government's emissions targets and developing local actions towards combating climate change.

During 2010/2011 the council completed the Carbon Trust local authority management programme; and developed a robust plan to tackle Carbon emissions. The Council has set an aspirational target of reducing its carbon footprint by 40 per cent of 2009/10 levels by April 2015.

The Council see the development of renewable energy sources as an important opportunity to reduce their carbon footprint, and through working with their registered provider of social housing - Golden Gates Housing Trust (GGHT) – to bring significant local economic benefit to the borough; and to save nearly 500 tonnes of carbon per year from renewable energy.

The Council are supporting GGHT to install solar photovoltaic panels (PV) on properties owned by the Trust in "Closing the Gap" areas (subject to capacity of the electricity network) containing the top 5% most deprived areas in England; and 1 in five residents claiming unemployment benefits. The project is clearly aimed at supporting local economic benefit for local residents; and is aimed at reducing energy costs for tenants, potentially taking some tenants out of fuel poverty.

The pilot project involves the Council prudentially borrowing to fund the supply and installation of PV; and hopes to generate a surplus from guaranteed feed-in-tariff payments, shared with the Housing Trust, over the 25 years of the project. The project is being timed to fit with other investment in energy efficiency measures including: ensuring that every window has double glazing; installation of modern efficiency heating systems; and loft insulation.

## Conclusions and Recommendations

Social entrepreneurs, and the ventures they lead, continue to bring innovative solutions by combining a social mission with sustainable business models. They provide real ways for interested citizens and communities to get involved in tackling inequality and building a better society; and generate social value in a way that is financially self-sustaining - by accessing external investment to maintain and potentially scale their impact.

Social Impact Bonds are likely to be major investment tools for the future. As they are still in the pilot stage there are likely to be some issues which need to be resolved as the projects go ahead. Nevertheless, the idea has been enthusiastically received by the coalition government as well as the private and third sectors, suggesting that if the right projects are put forward there will be a demand to invest in initiatives.

Revitalizing public service policy to embrace social innovation and investment will spur new ways for the public, private, and community sectors to work together, offering opportunities to strengthen social partnerships and leverage new sources of capital for public good. New models of social finance and funding are already emerging apace. Revolving funds have been used successfully to kick start initiatives in many places across the UK, as well as providing a platform for re-investing returns on investment in additional infrastructure and services.

[9] The Government's £20M investment in the fund in 2002 attracted £120M of private impact investment over six years and likely contributed to the development of over £325M in other social venture capital funds.

Significant potential also exists for government (at all levels) to use such sources of finance to support local communities to develop schemes which deliver local economic, social and environmental benefit. Kirklees Council launched its £2.7 million Re-Charge fund in 2008. It is now completely lent out, with loans made to around 285 local households. Under the scheme, the council offers homeowners an interest-free loan of up to £10,000. The loan is secured to the property and is repaid to the council when the property ownership changes. Around 20% of the funds have supported households in fuel poverty[10].

There are four key messages or recommendations flowing from this bulletin on social investment:

- Identify areas, both geographically and in service terms, where there is greatest need for social investment;
- Develop closer social responsibility relationships with the private sector and potential social investors;
- Sell the value of social investment to Local Enterprise Partnerships as a means of economic growth;
- Use social investment as a mechanism of engaging and supporting the voluntary and community sector and social enterprise.

**Bulletin** is one of a series of regular policy reports produced by the Centre for Local Economic Strategies (CLES). CLES is the leading membership organisation in the UK dedicated to economic development, regeneration and local governance. CLES undertakes a range of activities including independent research, events and training, publications and consultancy. CLES also manages the monthly New Start digital magazine, through its new CLES online service, which provides comprehensive analysis and commentary on current policy and good practice.

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