[Bond Case Briefs]

Municipal Finance Law Since 1971

[How to Use Impact Bonds to Finance Social Good.]

In four short years, social-impact bonds—complex fixed-income instruments aimed at financing social good—have grown from an obscure experiment in the U.K. to a rising market force in the U.S. and abroad. Insiders say that the business will more than quintuple within a year and that the next innovative wave of impact bonds, sometimes called "pay for success bonds," will likely come from local U.S. governments. Currently in the pipeline: A $7 million bond in Salt Lake City, Utah, aimed at boosting early education; a $17 million instrument to improve pre-kindergarten literacy in Chicago; and a $4 million deal tackling homelessness in Cuyahoga County, Ohio.

But let's back up. Social-impact bonds are a collaborative effort between philanthropically minded investors, nonprofits, and governments intent on solving social ills, while paying investors a return. Private investors provide project financing for nonprofits working to cut future public-sector costs by doing things such as reducing repeat youth incarcerations by 10%. When benchmarks are hit, investors get a return, based on what the government saved by not keeping such individuals in jail.

For all their 21st century ethos and excitement, social-impact bonds are still a tiny business; there are just seven in the U.S. According to the Rockefeller Foundation, there are about $80 million in impact bonds in the country but it expects the domestic market to grow to $500 million by year's end. President Obama's 2015 budget called for $300 million to build out the social-impact bond industry. Outside the U.S., Australia, Canada, Germany, Columbia, India, and Israel are either already in or in the process of joining the social-impact bond business. (See Penta's Jan. 13, 2014, ["Pay for Success Bonds Drum Up Interest"] at Barrons.com.)

The largest U.S. deal to date is in Massachusetts, with $28 million in funding going to local nonprofit Roca, which tackles youth recidivism in the state's prisons. Roca literally takes ex-felons off the street and transports them in vans to its programs in Boston, Chelsea, and Springfield, where a dogged combination of therapy and work-training programs prepare them for life outside prison. Over the bond's seven-year maturity period, which started last January, Roca will support 929 at-risk males, 17 to 24 years old.

Investors in the Roca deal include Goldman Sachs and the Kresge family's foundation. If Roca hits its target—to trim the number of days ex-offenders are imprisoned by at least 40%—investors will be paid a 2% to 5% return annually, with lower incarceration rates triggering higher payouts. That relatively low return appeals only to the philanthropically minded investor, of course, but it's a great deal for Massachusetts, which could save as much as $7 million, even after paying off investors, if Roca hits its most ambitious target. But social-impact deals like this remain stunningly complex. "There's no blueprint here and we're working with four branches of government and across eight institutions with all different kinds of money," says Roca CEO Molly Baldwin. "Would we have wanted it to be smoother? The answer is yes."

Critics question social-impact bonds' viability. In August, the world's first such bond – in Peterborough, U.K., and also dealing with recidivism—missed its initial 10% reduction target, which would have triggered an immediate repayment of investor principal. Still, the reading came in at a respectable 8.4%; if the reduction in repeat imprisonments stays above 7.5%, the U.K. Ministry of

Justice will return money to investors. “The performance of the first group indicates that investors are on track to receive positive returns in 2016,” says one investor, the Rockefeller Foundation.

Meanwhile, the Laura and John Arnold Foundation, a family foundation in Houston, has made grants and loans worth $14.4 million to help develop the social-impact bond industry, and has invested directly in three impact bonds, including the Roca deal.

Josh McGee, a vice president of the Arnold foundation, says that, as currently structured, the deals take too long to complete. “There is a real question in the space right now about the best way to organize deals,” he says. He’s focusing on locally sourced social-impact bonds, such as the $4 million Cuyahoga County bond, structured around homelessness. McGee thinks local governments will ultimately prove more nimble than the lumbering states at structuring deals. In short, the nascent social-impact bond industry is ratcheting its way up the learning curve.

Barron’s

January 2, 2015, 2:15 P.M. ET

By Robert Milburn