GFOA: The Perils of “Benefit Bonds” and Social Impact Bonds.

At “Just Say No: Financial Products and Strategies to Avoid,” a Tuesday session at GFOA’s annual conference, the panelists discussed the pitfalls of newer, more “innovative” financial instruments that local governments have access to.

Pension and OPEB obligation bonds were discussed first. The prospective benefit of these “benefit bonds” is that the investment income that the government earns on the bond proceeds would exceed the interest paid out to the bond buyers. Gaining this benefit requires the government issuer to correctly time the market so that the time period of the borrowing takes place during a time period in the economy when the returns on investments exceed cost of borrowing—something that is easier said than done. Further, benefit bonds can even lead to poor decision-making about future benefit levels. This is because the bonds cause the government’s benefit liability funding ratio to appear to be improved – the bond proceeds are used to fund the liability. However, this doesn’t take into account the offsetting liability of the need to repay the bonds. Hence, this illusory improvement might offer improved benefits to plan participants.

For more information, see GFOA’s advisories:

- Other Postemployment Benefits (OPEB) Bonds
- Pension Obligation Bonds

Social impact bonds are another financial instrument we’ve been hearing about. Most of them follow a basic formula – private investors pay a government to launch a new social program that’s designed to achieve a measurable result. If the program works, funders get their money back, and some or all of the savings attributable to that result. If it fails, the funders lose most or all of their investment. Most social impact bond programs are usually delivered by non-profits that want to try innovative approaches to solving social problems. If the program works, the participant that fronted the money (usually an investment bank) gets investment back plus a return, which comes from cost savings (from small case studies, less expensive cases, and so on). If the project fails, the investor loses its investment.

These investments are incredibly complex, multi-year undertakings, and the first thing a local government considering one needs to determine is whether it can commit to putting a lot of resources into managing the project for a long time. Sophisticated, solid program evaluation is required throughout the program.

The main advantages to social impact bonds are:

- There’s a lot to be said for focusing on impact, not outputs or throughputs (despite the difficulty).
- These projects are often about applying a little prevention (to, say, decrease homelessness), and a little prevention goes a long way.
- This can provide an opportunity to “backfill” federal and state funding that had been lost after the recession.

- Evidence-based policy is generally a good idea for new service delivery models.

The main concerns, and they are significant, are:

- It’s difficult to measure impact. How is it defined? How do we get the data to measure it? How do you isolate the program’s effect on second graders’ reading? Even the most sophisticated measures can’t single this sort of information out.
- Does “pay for success” imply that what we’ve been doing up until now is paying for failure? Some would say yes, but in many cases, this is not the case, and it does a disservice to the many government projects being run well and producing excellent results.
- What are “cost savings”? Is reducing marginal costs alone a compelling reason for social impact bonds?
- There’s upside risk. If a social impact bonds reduce costs more than expected, is there gain sharing for governments? Some programs have been wildly successfully, and the last thing you want to see is a headline that says “Goldman Sachs profits wildly from investment in City X.”
- Are social impact bonds sustainable without the role of philanthropy?

Why should finance professionals care? Because it’s going to start coming up more and more often. The idea has great headline appeal – no elected officials will want to avoid an opportunity to “leverage private sector and philanthropic investment to transform the lives of children.” Any finance officer approached bout a social impact bond deal should do a thorough feasibility analysis.

Government Finance Officers of America

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