

7 May 2015

The Future of SBBs: Delivering investor returns and achieving social benefits

Peter J Taplin
Director, Structured Finance
Corporate and Structured Finance
[Westpac Institutional Bank](#)

I've heard Jane's story a few times. It never ceases to bring a tear to my eye. It reminds me, better than a battery of statistics, that there is real disadvantage in our community. It also brings a tear of joy knowing Westpac and I have played a part in affecting such positive social change. While a donation would be as effective in rendering the outcome, it is the innovation of the social benefit bond and its potential uses that excites the most.

With the federal budget now less than a week away, we are daily reminded of the constraints governments face in dealing with society's social challenges. Because government cannot easily avoid funding a social safety net, all too often it is prevention programs that have second dibs on precious funding. As Wendy's predecessor described it, we fund the ambulance arriving at the bottom of the cliff rather than the safety rail at the top that would stop people falling in the first place.

We believe social benefit bonds have an important role in funding such prevention and early intervention. If they are successful the savings from having fewer ambulances can be distributed to investors and NGOs, and if not, governments still have the funds to pay for those ambulances. With the right program and intervention, social benefit bonds will deliver accretive positive social outcomes at long term lowest cost to government.

There is no shortage of needy causes or applications. Recent ideas to cross my desk include interventions in mental health and the funding of rehab clinics to dent the scourge of the ICE epidemic with payoffs tied to health, education and employment outcomes. So what is suitable for a social benefit bond?

In this speech I will canvass our thoughts gained from the coal-face of arranging/negotiating and selling the BenSoc bond, one of two social benefit bonds in Australia, and our involvement in the preliminary scoping of other social impact investment projects planned for New Zealand and other Australian states. Five things that need to be considered are Priority Areas; Size; Collaboration; Measurement and Government Leadership.

Priority Areas of Need

Social Benefit Bonds have developed internationally around government as the beneficiary of the achieved outcomes. While we don't see this as a limiting condition for the evolution of the sector, at present the immediate future of SBBs is tied to the willingness of government to trial such programs, and this means programs need to hit the government's sweet spot addressing areas where there is perceived greatest need and believed potential for the private sector to innovate.

The recently re-elected Baird government has ambition to complete two new SBBs per year with nominated priority areas being:

1. Managing chronic health conditions with the aim of reducing hospital entries and time in hospital;
2. Supporting offenders on parole to reduce re-offending rates;
3. Managing mental health hospitalisations which like chronic health is aimed at reduced hospital usage and also increased opportunities for those with mental illness to have greater participation in their communities, education and employment; and
4. Preventing or reducing homelessness among young people, with those exiting foster care being seen as a potential target group for specific intervention.

Social and affordable housing is also a target area, important enough to be subject to its own Premier's Innovation Initiative project.

Finally, because the government is acknowledging they do not have all of the answers there is also the opportunity to tender programs that address alternative areas of need. As these have not been subject to existing scoping, we would expect proposals in the open category to be more challenging to implement unless they are evidently compelling. Other governments in the region that are also seeking to run pilots of SBBs have expressed similar areas of focus.

Size Matters

Size matters. Until the market develops greater scale and maturity, we believe larger programs are likely to be preferred by governments. This is simple economics – the costs of government and intermediary time is potentially large, and fixed, requiring sufficient scale to defray those costs. Westpac New Zealand recently tendered to the NZ government SBB pilot working with Turanga Health to develop a program to improve health outcomes of the indigenous Iwi in the Gisborne area. While government acknowledged the appropriateness of the chosen measurement framework and need, at a target size of \$1m, it was deemed there were alternative scalable programs that should be prioritised. This creates a challenge for smaller organisations and we would recommend those NGOs to consider forming partnerships to deliver larger programs. Even for medium sized initiatives, the real value will be in their scalability. If we are lucky to discover better more efficient ways at addressing social ills, government should be able to leverage those findings.

Collaboration

SBBs are very much a project of collaboration. In working on the BenSoc SBB Westpac assisted in preparing economic models to calculate expected savings to the state, developed the measurement framework, designed the bond structure, in particular the target risk and return profiles of the various classes of bond, co-ordinated the legal drafting and marketed the security to end investors. It was at times a challenging task. At its most basic it required learning a completely new language. The ethics of a randomised trial doesn't come up in day to day banking! Recognising the need for effective collaboration in the development of holistic proposals, NSW has initiated an Expert Advice Exchange. Westpac is a believer in the power of SBBs and the development of a market for them. We have agreed to provide our services to the EAX on a project by project basis working with proposals in targeted areas of interest, specifically proposals in out of home / foster care, reducing hospitalisations/managing chronic health, preventing or reducing homelessness amongst young people and social and affordable housing. We envisage offering assistance on program design and logic, corporate and operations strategy, financing and funding strategies, stakeholder engagement, risk and project management, financial management including financial modelling, planning analysis and drafting. Applying our skills and experience to make a meaningful difference to pressing social issues is part of our broader sustainability mandate and we are excited by the potential to develop economic tools to help support social change.

Beyond the scope of our advice, Westpac also seeks to deploy 2 billion by 2017 in addressing homelessness, including social and affordable housing.

Westpac and CBA, our partner on the SBB, are being joined by some of the leading law practices in the city in providing advice to the EAX. We encourage the other banks to similarly offer their time and expertise. This is one tangible way for the private sector to jump on board and help to develop

SBBs as a sustainable and viable financial market for future generations. Corporates can and should also have a say. If the EAX can achieve a shorter development cycle, and make it easier to construct these bonds, then the time invested will be valuable indeed.

Measurement

The two SBBs completed demonstrate that with the right financial structure and return profile there is investor demand for these products. But, at the present time there is no honey-pot of investors queuing up to buy social benefit bonds. Success of existing programs and greater awareness is helping foster interest. At the cutting edge, sector-leading investors like QBE are willing to allocate funds internationally to such investments because their performance is uncorrelated to other traditional investments. And the back-story is great – there are really no other ways for investors to invest in civil society alongside government. Notwithstanding these encouraging signs, large-scale capital will only be sustainably available if the returns are commensurate with the risk. Measurement plays a critical role in addressing this balance quite aside from social impact.

Investors are not interested in losing their capital, so showing a track record is important. Inevitably this will require greater investment by NGOs in data capture and robust analysis of performance. We see an important role for philanthropists and charitable foundations to provide grants to NGOs to assist in the development of this critical activity. And as true innovation is the aim of the social impact bonds, an investment in small scale trials as a stepping stone to proof of concept will be critical in the development of the market to its full potential. This is a necessary investment in being informed so that we may all make better decisions in allocating scarce resources.

The nitty gritty of agreeing a baseline and measurement set for any given program design is also challenging stuff. Many considerations need to be balanced.

Firstly, there is a trade-off between complexity and accuracy. Wholesale investors generally do not have the toolkit to understand complex measures of program success because the newness of these types of programs means there is a gulf of asymmetry of knowledge. Accordingly, the program, the means of achieving success, and the measurement of success for payments needs to be chunked down. Unless you can capture this in one paragraph, it is probably too complicated. But simplification is not without risk. We agonised over appropriate measures in the SBB. TBS were concerned that if we overly simplified the measurement, there was a risk that the chosen measures indicated failure whereas the program was actually successful on a wider range of measures. Given the public profile attached with apparent failure, their concern is an understandable one. The middle-ground is likely to be some form of balanced score-card.

Secondly there is the question of objectivity and access to data. Privacy considerations can impede access by NGOs to government data. Without trusted exchanges of data, the goal of learning by design and results during the program phase is impeded. Absent transparency, investors and NGOs may be pushed to investing on an article of faith basis. Then there is the issue of consistency of data through time in developing baselines. I suspect the experiences of my sister in law may be indicative. She is investigating infant vaccination rates for Hepatitis B across the NSW health system. The separation and aggregation of district health networks has left data in inconsistent form, requiring homogenisation and judgement in developing a base case.

Government Leadership

The Public Sector Comparator has been developed to benchmark costs of service delivery in an activity based world. An equivalent is required for outcomes in an outcomes based world. Beyond that, we believe government needs to think about the price they are willing to pay to achieve those outcomes – effectively merging the discipline of cost benchmarking to outcomes.

It is hard to put a price on an outcome. Let us be honest - Jane's outcome is priceless. But, price signals matter to the private sector. We would like to see a world where government was clear that it was willing to spend up to a dollar amount for an outcome to be achieved. This way, NGOs and investors can form a balanced view as to whether there is enough in it for them to pursue programs targeted at that particular area of need.

Doubtless there may be investors and NGOs who are willing to accept less. Competition to provide programs can ensure government gets best value for money. And when we have learned that a particular program is effective, the government can tender for work on an activity basis for lowest cost. This way budgets are not endlessly burdened over-paying for outcomes, while giving flexibility to pay up for innovation in achieving aspirational targets. Understanding the value of intervention is hard for government. While there is acknowledged value outside of the sponsoring department, the economics tends to boil down to the budget of that given department. Cross department collaboration is desirable and necessary. Beyond the matter of money and benefit, better collaboration can help identify problems in the community earlier, allowing services to work before disadvantage becomes entrenched.

So what about the future?

We want to champion bigger deals – funding infrastructure like housing and technology alongside services that will use the infrastructure. Investors may part with their funds more readily if they can see tangible property being financed.

Lastly, I flagged earlier that we did not see government involvement as being a limiting factor in the growth of the SBB market. Corporates can also play a role. If a corporation can benefit financially from an improved social outcome, then there is foundation for the corporation to be the sponsor of the bond. Yes, there are obstacles – imagination, planning, and the real possibility that others, including competitors also benefit from a successful program – another form of the “free rider” problem.

Wouldn't it be great if our leading health companies, Ramsay and Healthscope, saw benefit in reducing hospitalisations, in the same way that government benefits. These companies should be able to participate in reward from people staying healthy as well as when they are sick.

Pockets of homelessness are clearly not great for apartment developers trying to sell the flash new development around the corner. Developers like Lend Lease and Mirvac can benefit from the outcome, not just because it means there are more people in the market looking to buy those properties in the long term.

And in remote mining sites, miners such as Fortescue clearly benefit from a more engaged workforce, meaning that aboriginal welfare is part of being successful.

The sky is the limit, if we are willing to dream.

In closing, the wisdom of Ban Ki-moon is apposite. “One of the main lessons I have learned during my five years as Secretary-General is that broad partnerships are the key to solving broad challenges. When governments, the United Nations, business, philanthropies and civil society work hand-in-hand, we can achieve great things”.