



WOULD-BE INVESTORS IN MINNESOTA

state bonds may soon see a new product on the menu. But this paper wouldn't support the construction of bridges, highways or anything else that state-issued bonds typically fund. True to its name, the human capital performance bond, or HuCap, would finance publicly funded programs that seek to improve people's lives.

Still a work in progress, the HuCap owes its existence to Steve Rothschild, a former vice president at Fortune 500 food company General Mills. In 1994, three years after resigning his post, Rothschild founded Twin Cities RISE!, a Minneapolis nonprofit that provides career training to unemployed adults and helps them find jobs that pay a living wage. Soon after he launched TCR!, the onetime corporate executive began thinking about how to quantify its economic benefits. He also wondered if any savings to taxpayers could be funneled back into his organization.

"I started with the assumption that social improvement would lead to economic value," says Rothschild, 66, who has an MBA from the University of Pennsylvania's Wharton School.

In 1995 he approached Minnesota government officials with an idea for a radical new social services financing structure: The state would fund TCR! based on its success — higher tax revenues and lower spending on welfare subsidies, food stamps and other social assistance. The Minnesota legislature approved this so-called pay-for-success model the next year, and TCR! implemented it in 1997. Since then, Rothschild says, the state has invested \$4.6 million in his nonprofit and reaped \$34 million in economic value.

Despite that impressive track record, Rothschild has hit a funding wall. "Even though we're getting great returns, we can't convince the legislature to invest more money into the possibility of earning it back, because they just don't have the cash," he says. Like many states facing huge budget shortfalls, Minnesota has been forced to cut spending across the board. Last July legislators slashed the state's \$5 billion deficit only after a 20-day government shutdown.

But Rothschild hasn't given up on growing TCR!, where he serves as chairman of the board. Recently, he's pinned his hopes on one particular source of capital: institutional investors. If pension



GREEN SHOOTS

STATE CAPITALISM

Institutional investors could play a big role in pay-for-success social programs.

●● **BY RATIE GILBERT**



funds and socially oriented mutual funds had access to a product that allowed them to finance successful social programs like TCR!, he reasons, his and other nonprofits could expand their reach. As Rothschild explains, such a program would only tap investors' funds if an independent assessor deemed it a public-money-saving success.

Investors would get their principal back, plus a return, from the same government coffers that presumably are benefiting from higher taxes and fewer subsidies and other costs.

Rothschild is off to a good start. In July the Minnesota legislature signaled its support for his HuCap bond by approving \$10 million in bonding authority for a pilot program. The state is developing a working capital fund and looking at options for selling the bonds.

Far from being a Minnesota oddity, the pay-for-success concept is grabbing the attention of lawmakers from coast to coast. A stagnant U.S. economy, a \$1.3 trillion federal deficit and serious budget

MAXWELL HOLYOKE-HIRSCH

pressures across various states and localities help explain its appeal. The state of Massachusetts and New York City have taken big steps toward integrating pay-for-success into their financing of social programs. Indiana, Michigan, New York State, Virginia and parts of California are also exploring the idea.

Washington likes this financing model too. In his proposed 2012 budget, President Obama earmarked \$100 million across five federal agencies — the Departments of Education, Justice and Labor; the Social Security Administration; and the Corporation for National and Community Service — to adopt pay-for-success funding strategies. Although Congress failed to approve that budget, the administration's interest remains strong. In late October the White House cohosted a meeting of officials from federal, state and local governments, as well as representatives from nonprofits, academia, philanthropic organizations and intermediaries, to discuss pay-for-success contracting.

This event served as a “green light to the agencies to begin looking at where the opportunities are” to integrate pay-for-success, says Marta Urquilla, senior policy adviser to the White House's Office of Social Innovation and Civic Participation, which shared hosting duties with the New York-based Nonprofit Finance Fund.

A U.K. pilot program offers the first real glimpse of what pay-for-success investing would look like in practice. At HMP Peterborough, a prison north of London, three nonprofits are launching initiatives

that aim to reduce prisoner recidivism upon release. They're drawing on a £5 million (\$7.9 million) pool of capital raised from private individuals and charities by London-based Social Finance, an investment bank focused on the social sector. Independent assessors will keep track of recidivism rates among offenders released from Peterborough and compare them with those of a control group from another jail.

If Peterborough's rates are at least 7.5 percent lower than the control group's, the British government will pay investors a return of between 7.5 and 13 percent. But if the Peterborough program fails to meet the minimum threshold, investors receive nothing. This pilot's investment product is called a social impact bond, but its all-or-nothing risk profile means it's not actually a bond, unlike Minnesota's HuCap, which covers investors' risk.

Interest in pay-for-success and its related investment products may be broad, but the model remains unproven. The investors who finance the first few rounds of pilot programs will be philanthropists, high-net-worth individuals and foundations — those who care more about the social impact of an investment than its risk profile and are unfettered by a fiduciary responsibility to maximize returns.

Several of the intermediaries helping to lay the infrastructure for a pay-for-success financing market are trying to engage institutional investors, the group that they contend will be crucial to revolutionizing the evaluation and funding of social programs. “We're very

mindful of making sure that the investment instrument is built such that we're able to attract institutional assets over time,” says Tracy Palandjian, Boston-based CEO and co-founder of Social Finance's U.S. sister organization of the same name. At the Clinton Global Initiative's annual meeting in September, Palandjian's nonprofit pledged to develop \$100 million worth of pay-for-success products over the next two years. “We can't get to \$100 million with just foundation money,” she says.

Palandjian has talked to a handful of pension funds about the potential of pay-for-success investments. So far, those with economically targeted investment programs have shown the most enthusiasm. Such programs focus on investments in the fund's geographic region that offer strong risk-adjusted returns plus a local economic payoff — a snug fit for pay-for-success products, Palandjian says.

Antony Bugg-Levine, CEO of the Nonprofit Finance Fund, believes institutional investors will find more to like about these new investment products than their social perks. “This offers the promise of being a very noncorrelated asset for an institutional investor,” says Bugg-Levine. He points out that a HuCap-type investment would carry two main types of risk: execution risk (the possibility that the nonprofits en masse would not achieve their desired outcomes) and political risk (the chance that the government wouldn't make good on its promise to pay investors out of the savings incurred). Typical market risk doesn't directly affect the investment.

Industry observers say institutional investors' role in the pay-for-success setup will provide a healthy dose of market discipline along with a supply of capital. George Overholser is co-founder of Third Sector Capital Partners, a Boston- and New York-based nonprofit that's acting as an investment-bank-like intermediary in the development of a market for social impact bonds and their variants. He says it's important for institutions to bring some much-needed rigor to the allocation of social funding.

On that note, the Washington-based Coalition for Evidence-Based Policy recently released a staggering figure: Of the ten major federal social programs that have been rigorously evaluated in randomized controlled trials since 1990, just one made a statistically significant impact. Overholser thinks that pay-for-success contracting between nonprofits and governments will help drive the duds from the system and that investors will play a key role in pushing for better measures of success. “The presence of these powerful investor voices in what used to be a smoke-filled political back room will force an insistence on high-quality measures of social impact,” he says.

Regardless of how and why they may eventually get involved in pay-for-success programs, institutional investors would do well to follow the development of HuCap and similar investment products. Whether or not pay-for-success is the model that sticks, the White House's Urquilla predicts that the public sector will show more interest in working with private capital to address social issues too big for it to handle alone.

The Nonprofit Finance Fund's Bugg-Levine echoes that sentiment. “Government will need to be working alongside investors to unlock capital that is currently sitting in investments focusing solely on financial return,” he says. “We are not going to be able to ignore the capital markets and their potential to participate in solving social problems.” ●●