Bridging the social divide: harnessing entrepreneurship and investment to achieve social goals.

By Sir Ronald Cohen[1]

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Summary:

The current wave of social entrepreneurship and impact investment, combining enterprise and capital to address social issues, promises to transform the entire social sector. Conditions are favourable for this wave to sweep across the world. Everywhere, social need is increasing while, proportionally and in some cases in absolute terms, government expenditure is decreasing.

At the same time, an entrepreneurially-minded generation has graduated from business schools, start-ups, high-growth businesses and the social sector itself. These entrepreneurs want to make a beneficial social impact. They are among our brightest and best. They have understood that society is becoming unstable and that it is inequitable for people to be left behind. They would like to give others a chance. Given the opportunity, they will apply private-sector investment and management techniques to social enterprises and develop private-sector standards of effectiveness and performance measurement.

Working in tandem with impact investors, social entrepreneurs are tackling social issues and in the process creating the new asset class of impact investment, which combines financial and social returns. Such an asset class should be a welcome addition to the investment markets, providing diversification and encouraging innovation. It should also make a big social contribution, leading to greater utilisation of our human capital and fostering greater social cohesion at a time when both are sorely needed.

But for this vision of a powerful "social impact sector" to be fully realised, the evolution underway in the mindset and role of the social sector as well as investors must accelerate, and governments must introduce enabling legislation and regulation and support the adoption of new financial instruments such as Social Impact Bonds that enable not-for-profits to access capital markets.

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Broadly speaking, capitalism does not deal with its social consequences. Even as communities grow richer on average, so the gap between the "haves" and the "have-nots" increases. For example, since the mid-1970s, both the USA and UK have actually become less rather than more equal. According to OECD data, the USA's and the UK's Gini coefficients (where 0 represents perfect equality and 1 represents perfect inequality) moved from 0.32 and 0.28 respectively in the mid-1970s, to 0.38 and 0.34 in the mid-2000s[2]. The bottom half of society in the USA owns just 3% of the country's wealth and 19% of US households are, according to the OECD, below the poverty line. In the UK, the equivalent figures are 5% and 9%[3]. This is injurious to the have-nots, whose key social indicators, including longevity, health and educational attainment, are, unsurprisingly, worse than that of the haves. But it also means that, as long as the have-nots languish in unemployment and social disadvantage, society is not making optimum use of its human resources and there is a continual risk of social break-down. Between April 2007 and March 2008, the employment rate in England's most deprived areas was 56.7% of the working-age population, compared with 76.4% in the rest of the country – a gap of 19.7 percentage points[4]. The gap increases in times of crisis: the rate of unemployment[5] in deprived areas of Great Britain rose from 8.7% in Q1 2008 to 11.3% in Q1 2009. This is a 35% greater increase than that among the UK population as a whole, which saw a rise from 5.4% to 7.3%[6].

It is true that in the long post-war boom many governments did make significant headway in ameliorating the consequences of social inequality. This can be seen in levels of investment in areas such as health and in critical performance measures such as life expectancy. Nevertheless, governments, despite their best efforts and even in the best of times, have not been able to resolve all social problems.

Commentators on one side of the political spectrum attribute this failure to the lack of resources available to the state and to the state's reluctance or inability to act appropriately. Commentators on the other side attribute government's shortcomings to the inherent inefficiency of the state itself. The truth is that the political process, which focuses on short-term gains, does not favour long-term, preventative investment of the type required to address major social problems.

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[2] The Gini coefficient takes a value between 0 and 1, with 0 representing a perfectly equal distribution and 1 representing 'perfect inequality'.

Income Distribution – Inequality [Gini coefficient (after taxes and transfers)]						
Period	*Mid-70s*	*Mid-80s*	*Around 1990*	*Mid-90s*	*Around 2000*	*Mid-2000s*
United States	0.32	0.34	0.35	0.36	0.36	0.38
United Kingdom	0.28	0.33	0.37	0.35	0.37	0.34

From "Growing Unequal? Income Distribution and Poverty in OECD Countries", Figure 1.2 :Trends in Income Inequality.

[3] Center for Global International and Regional Studies, University of California, Santa Cruz; OECD statistics on poverty rates. The OECD takes all households with children where the head of the household is of working age. Those households with less than 50% of the median income in the country in question are deemed to be in poverty. By this measure, 13% of households in Canada and Germany, 10% in Germany and 7% in France are below the poverty line.

[4] "Department of Communities and Local Government Report, "DSO 3.7; Overall Employment rate (working age population) at neighbourhood level (in deprived areas), England. February 2010.

[5] International Labour Organisation (agency of United Nations) measure based on economically active population

[6] Equality and Human Rights Commission "Monitoring the Impact of the Recession on Various Demographic Groups", Department of Work and Pensions and Government Equalities Office, June 2009. http://www.dwp.gov.uk/docs/monitoring-impact-recession-demographic-groups.pdf.

The social sector (or the social impact sector, as we should perhaps more appropriately start to call it to reflect the transformation underway in its mindset and roles), which is also called the voluntary, non-profit or third sector, has done its best, with the support of philanthropic donations and government, to address the social problems that fall through the gaps in government provision. In aggregate, the sector is very significant in size. As of July 2009, there were 987,000 registered public charities in the USA and 116,000 private foundations[7], between them deploying over $683 billion of charitable foundation assets[8]. In 2004, employment in the US charitable sector was 9.5 million[9]. In the UK, the sector comprises 200,000 not-for-profits, 840,000 full-time-equivalent employees and over £95 billion of income and endowment funds[10]. But, disaggregated, we find that most social sector organisations have no more than a few months of funding at their disposal. In the USA, 85% of non-profit organisations operate with annual budgets of less than $100,000. In the UK, 53.2% of charities are micro-charities with annual incomes of less than £10,000, while large charities, with annual income of between £1 million and £10 million, represent just 2.4% of the sector. This data could be taken as *prima facie* evidence of excessive fragmentation in a sector which, in the UK, relies on donations by individuals for 37% of its income[11], and few would dispute that the contribution made by the social sector falls short of meeting the need[12].

Some argue that the social sector's problem is that it is significantly under-resourced. Others argue that the insufficiency of resources is in part a consequence of the sector's reliance upon philanthropy - from foundations and from individual donors - that can be unpredictable[13]. Is the insufficiency of resources available to the social sector the fault of a "philanthropic deficit" (i.e. not enough giving) or is it the fault of the inherent inefficiencies of the social sector itself (i.e. it does not deliver enough added value such as would stimulate additional giving)? It may be that both critiques are correct: the social sector has a problem in accessing capital, often because of a lack of a reliable revenue stream, and, as a consequence, it is inefficient, especially in respect of building sustainable organisations, securing funding and utilising assets to support large-scale activity[14].

Recent moves to make the social sector more efficient, by focusing on improvements to the management of both the donors and the recipients of grants, are an important development. The Bill & Melinda Gates Foundation applies rigorous criteria to the assessment of the performance of organisations in receipt of its grant funding. Michael Dell's philanthropic work is similarly rigorous. Their goal, according

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[7] Urban Institute National Center for Charitable Statistics.

[8] Giving USA 2007: Giving USA 2008: Foundation Center; Andrews, F. Emerson Philanthropic Giving (1956).

[9] Lester M. Salamon and S. Wojciech Sokolowski, Employment in America's Charities: A Profile, The Johns Hopkins Center for Civil Society Studies, Nonprofit Employment Bulletin Number 26, December 20.

[10] UKCivil Society Almanac 2010, National Council of Voluntary Organisations Section 3, www.ncvo-vol.org.uk/almanac2010.

[11] UK Civil Society Almanac 2010, National Council of Voluntary Organisations. www.ncvo-vol.org.uk/almanac2010.

[12] Social Justice Policy Group "Breakdown Britain - interim report on the state of the nation" Centre for Social Justice December 2006.

[13] National Council for Voluntary Organisations, Sustainable Funding Approach. http://www.ncvo-vol.org.uk/advice-support/funding-finance/sustainable-funding/sustainable-funding-approach.

[14] New Philanthropy Capital "Little Blue Book for analysing charities": www.philanthropycapital.org/publications/improving_the_sector/charity_analysis/Little_blue_book_download.aspx.

to Harvard professors Robert Kaplan and Allen Grossman, is, essentially, “to find and fund the Microsofts and Dells of the non-profit sector”[15].

In fact, such moves are more than ever necessary, as deficit-ridden governments seek to pass greater responsibility onto the shoulders of the social sector. An example of this is the UK Coalition Government’s strategic objective to foster the “Big Society”. In essence, the Big Society agenda seeks to pass a significant portion of responsibility for social cohesion back to the community via the voluntary sector, and, at the same time, to confer greater legitimacy upon such community work and to provide incentives and support for it. Questions about the Big Society are rife on both sides of the political divide. Commentators ask: “Where will the resources come from?” and “Why should the fragmented and often localised social sector be any more efficient than the state?”[16]

Such questions, while often couched in partisan language, are nonetheless warranted to some degree. For, even with greater efficiency of management and greater focus on real, measurable outcomes, the social sector as currently constituted is unlikely to be able to address the scale of the social need; or, to put it another way, to meet the scale of the social challenge.

This is where social entrepreneurs come in. We know that entrepreneurs create jobs and foster innovation. In that sense, they already make a substantial social contribution. But entrepreneurs have special qualities that could make a significant beneficial impact were they to be applied to social issues. There is room for debate about the nature of entrepreneurship but any list of its qualities must surely include a mindset that embraces leadership, vision, the ability to attract talented people, drive, focus, perseverance, self-confidence, optimism, competitiveness and ambition. To these one might add an appetite for taking informed risks, an unwavering focus on results, a willingness to take responsibility, a grounded sense of realism, astute judgement of opportunities and people, and a fascination with the field of enterprise in question[17]. Whatever combination of these characteristics we might settle upon, we can surely agree that they do not tend to be found in abundance in government or in the social sector as currently constituted.

Entrepreneurs tend not to be inhibited by the extent of their current resources. To borrow a metaphor from Elizabeth Barrett Browning, their reach exceeds their grasp. A key element in this regard is their ability to attract investment capital and human capital wherever they find opportunity. The engagement of entrepreneurs in the social sector, bringing in their wake high expectations of performance, accountability and innovation, could lead to significantly increased social impact.

The idea of harnessing enterprise in the service of social goals is not new. Some of our great commercial enterprises were originally founded by Quaker families specifically to address social needs. This was also the motive that underlay, for example, the co-operative movement in Britain in the 19th Century. What we are witnessing now is a re-birth of social entrepreneurship and a new wave of social, or impact, investing informed by the experience of enterprise and venture-capital investment over the last forty years. In April 2000, the Social Investment Task Force was set up in the UK to define “how entrepreneurial practices could be applied to

[15] Kaplan and Grossman, Harvard Business Review, 2010, p 114.
[16] Coote, Anna “Ten Big Questions about the Big Society”, New Economics Foundation, June 2010.
[17] Cohen, Ronald, “The Second Bounce of the Ball”, Weidenfield & Nicolson, 2007.

obtain higher social and financial returns from social investment"[18]. In October 2007, the Rockefeller Foundation hosted an international meeting of approximately fifteen impact investors – including foundations, investment managers and banks, among them most of the original council of the Global Impact Investing Network (GIIN), a non-profit organisation dedicated to building the impact-investing industry[19]. The following year, a broader meeting attracted forty such investors. They found that their common challenges included deal-sourcing, impact measurement and the lack of a common language to describe their investment activities. "In essence," reported a JP Morgan study, "these investors envisaged a well-developed, impact-investment marketplace that functioned like the traditional capital markets. They sought a marketplace in which investment opportunities are transparent and performance data is accessible, credible and comparable." Having identified these and other needs, the group set out to seed the organisations that would accelerate the development of the nascent impact-investing industry. They hoped that "helping to build an effective impact-investment infrastructure would attract new investors, by reducing deal-sourcing and transaction costs and providing examples of efficient impact investments"[20].

GIIN is in the vanguard of these developments, seeking to create a common framework for measuring social impact, to communicate the case for social investment, to lobby for supportive legislation and regulation, to develop effective self-governance, and to cultivate leadership[21].

Could the social sector be so transformed that it allows the emergence of entrepreneurs from within its own ranks and attracts social entrepreneurs and capital on a large scale? The answer to this question is yes, provided that we can create an effective system to support social entrepreneurship, by linking the social sector to the capital markets and introducing new financial instruments that enable entrepreneurs to make beneficial social impact while also making adequate financial returns for investors. Given these conditions, it is possible that social entrepreneurs and impact investors will significantly fill the gap between social need and current government and social-sector provision. Indeed, were social enterprise to achieve significant scale, it would transform the social sector and lead to a new contract between government, capital and citizens.

In this process, charitable, institutional and private investors, attracted by the combination of social as well as financial returns, would bring into being a new asset class: impact investment. In its report, JP Morgan came to the conclusion that impact investments already constitute an emerging asset class: "In a world where government resources and charitable donations are insufficient to address the world's social problems, impact investing offers a new alternative for channelling large-scale private capital for social benefit. With increasing numbers of investors rejecting the notion that they face a binary choice between investing for maximum risk-adjusted returns or donating for social purpose, the impact investment market is

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[18] Social Investment Task Force, "Enterprising Communities: Wealth beyond Welfare", 2000.

[19] The founding members of GIIN were Acumen Fund, The Annie E Casey Foundation, The Bill and Melinda Gates Foundation, Calvert Foundation, Capricorn Investment Group, CitiGroup, Deutsche Bank, Equilibrium Capital, Gerneration Investment Management, Gray Ghost Ventures, IGNIA, J P Morgan, Lundin for Africa, Lunt Family Office, Omidyar Network, Prudential, The Rockefeller Foundation, Root Capital, Shorebank/NCIF, Trans-Century, Triodos Investment Management, and Wolfenson & Company.

[20] JP Morgan, "Impact Investments: An emerging asset class", November 2010.

[21] Open Letter, Global Impact Investment Network (GIIN), December 2010.

now at a significant turning point as it enters the mainstream... We argue that impact investments are emerging as an alternative asset class."[22]

This new asset class requires a specific set of investment and risk-management skills; it demands organisational structures to accommodate these skills; it must be serviced by industry organisations and associations; and it must encourage the development of standardized metrics, benchmarks and even ratings[23]. As has been observed by the impact-investment firm Bridges Ventures in the UK, such an asset class should provide welcome diversification for capital markets: at times of economic stress, price-sensitive business models appropriate to lower income neighbourhoods can prove more resilient and also find wider applications in the mainstream market as both margins and consumer spending power are squeezed.

Not surprisingly, politicians as well as academics, entrepreneurs and investors are paying increasingly close attention to these developments. In the US and in the UK, and now also in Canada and Australia, steps are being taken to provide social entrepreneurs with access to the same kinds of resources as business entrepreneurs. The USA's Social Investment Fund ($173 million) and its Investing in Innovation Fund ($644 million) are notable examples; as is the proposed creation of the UK's Big Society Bank. In Canada, the Federal Government recently received the report of the Canadian Task Force on Social Finance, whose recommendations include requiring public and private foundations to devote a proportion of their funds to mission-related investments; clarifying fiduciary obligations so that pension funds and others can invest in social programmes; introducing new financial instruments for social enterprise; and marshalling government support for social enterprise, directly through seed investment and business support services and indirectly through fiscal engineering[24]. The New South Wales government in Australia has recently announced its intention to investigate the issuance of social impact bonds.

How likely is it that such steps will succeed? In answering this question, we would do well to consider that the global economy faced a similar moment of challenge and opportunity in the 1970s and 1980s, when many of the most familiar names in the post-war corporate world started to decline and shed jobs, among them General Motors, American Motors, Courtaulds, ICI, Smith Corona, Olivetti, US Steel, Bethlehem Steel, Kodak and International Harvester. The question then was: what would take their place?

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[22] JP Morgan, "Impact Investments: An emerging asset class", November 2010

[23] JP Morgan "Impact Investments: An emerging asset class", November 2010.

[24] Canadian Task Force on Social Finance "Mobilizing Private Capital for Public Good", December 2010. The report recommended 1) public and private foundations should aim to invest at least 10% of their capital in mission-related investments (MRI) by 2020 and report annually on their MRI activity; 2) federal and provincial governments should actively encourage pension funds to become impact investors by clarifying their fiduciary duty, mandating disclosure of responsible investing practices, and providing incentives to mitigate perceived investment risk; 3) governments should provide first loss/risk capital to catalyze private investment in both a series of regional impact investing funds across Canada and in a new federal fund of funds; 4) public, private and non-profit sector players should collaborate on the development of new financial instruments that increase the flow of capital for public benefit; 5) federal and provincial governments should modernize regulatory frameworks to permit charities and non-profits to undertake surplus-generating enterprises in support of their missions, and explore the need for a new hybrid corporate form for social purpose businesses; 6) government should offer targeted tax incentives that serve as a tool to attract private sector financing for impact investing; 7) the private and non-profit sectors, in partnership with the federal government, should support the establishment of an independent Impact Investing Performance Accelerator to build knowledge, capacity, performance metrics, policy advice and global networks around impact investing in Canada; and 8) federal and provincial governments should increase the availability of high quality business support services for social entrepreneurs by expanding externally provided programmes and by re-tooling government-funded SME programmes to make them more relevant and accessible to social enterprises.

What took their place was a new wave of business enterprise helped by venture investing, mostly focused on hi-tech industries. This is the wave that brought us Intel, Cisco, Oracle, Microsoft, Apple, Sun Microsystems and Genentech. The hi-tech wave has since swept the world, taking us into the embrace of Google, Wikipedia and Facebook and ushering in a communications and information revolution based on global access to information from multiple sources. It has thereby profoundly changed global culture.

Just as hi-tech business enterprise and venture capital, working in tandem, have attracted increasing numbers of talented risk-takers since the 1970s, so social enterprise and impact investment are now attracting a new generation of talented and committed innovators seeking to combine new approaches to achieving social returns. Social enterprise and impact investing, in short, look like being the wave of the future.

How will this prospect become a reality?

First, we need an enabling environment. In the 1970s and 1980s, the venture capital community argued successfully for changes in taxation and the regulation of financial institutions to foster investment in venture funds. Trade associations were founded. Governments were lobbied to improve the climate for start-up and early-stage ventures. Markets to raise equity and trade stocks in pre-profit companies were introduced in the USA (Nasdaq in 1970) and in the UK (USM in 1979). Rates of direct, personal taxation were reduced. And, in 1978, amendments to the USA's ERISA[25] legislation were specifically designed to foster venture investment by US Corporate Pension funds[26].

Such liberalising measures were adopted first in the USA, which, as it turned out, reaped most of the benefit of the hi-tech revolution, as is reflected in the flotations of new companies on Nasdaq. Apple, Microsoft, Oracle, Google, Cisco, Intel, Qualcomm, Dell, ADP, CTS, Yahoo, Broadcom, NetApp, AMAT, Adobe, Intuit, Activision, Symantec, Citrix, CA Inc, Sandisk, First Solar, NVIDIA, Altera and F5 Networks are young, world-leading, American, hi-tech companies. Many were supported by venture capital, all were floated on Nasdaq and all now have market capitalisations in excess of $10 billion.

Social enterprise and impact investment need similar rule-changes to foster investment in mission-driven ventures that deliver social returns in combination with financial returns. We need tax incentives, changes in the permitted scope of activities by charitable foundations, in the role of banks in low-income areas and in the rules governing institutional investment. In particular, the restrictions on investment by charitable foundations and financial institutions need to be adapted to enable the inclusion of social investment.

The Social Investment Task Force, which examined these issues in the UK over a ten-year period, 2000 – 2010, recommended the creation of a system to support social investment. Its specific proposals included the introduction of Community Investment Tax Relief, fashioned after the USA's New Markets Tax Credits; the formation of community development venture funds to take a long-term view of equity investment in poorer, underinvested areas; greater disclosure of the lending practices of banks in low-income areas to encourage best practice, following the US

[25] Employee Retirement Income Security Act
[26] "The Rise and Fall of Venture Capital" Paul Gompers, University of Chicago.

lead[27]; greater latitude and encouragement for charitable trusts and foundations to invest in community development initiatives; and the strengthening of the community development finance industry through the creation of a professional association, the Community Development Finance Association (cdfa), bringing government, banks and investors, on one side, together with business, social and community enterprises on the other.

These recommendations were taken up by the Labour Government and the decade witnessed the emergence or development of many social enterprises, including Charity Bank, CAF Venturesome, Big Issue Invest, Breakthrough, Investing for Good, CAN, Impetus Trust, Bridges Ventures, Social Finance, UnLtd and Social Investment Business[28]. The approach taken by the Social Investment Task Force has now been strongly endorsed by the new Coalition Government.

Others have argued for additional tax reliefs on social investments and the formation of a cornerstone fund to seed such investments[29].

In the UK, new draft guidance from the Charity Commission on charity trustee powers of investment is a response to pressure from social entrepreneurs and others to allow and encourage trustees of UK foundations and charitable trusts to allocate a portion of assets to social investments[30]. Other countries without a body such as the Charity Commission may need changes to financial regulation and legislation. Once a track record has been established for interventions that generate sufficient financial returns, we would expect similar regulatory encouragement for pension funds, so that social investments could be included within the definition of prudent investment.

Next, in line with the recommendations of the Social Investment Task Force, there needs to be a wholesaler of capital to channel capital into the social sector, which has, to date, been disconnected almost completely from capital markets and so has suffered from

UK Big Society Bank milestones

March 2007: **Commission on Unclaimed Assets Report – "The Social Investment Bank: Its organisation and role in driving development of the third sector"** – outlines the need for a wholesale institution to develop a market in social investment in the UK, on the lines anticipated by the Social Investment Task Force in its 2000 report.

November 2008: **Dormant Bank and Building Society Accounts Act** prescribes that unclaimed assets can be used for youth services, financial literacy or to establish a "social investment wholesaler".

July 2009: **"Social Investment Wholesale Bank: a consultation on the functions and design"** – Office of the Third Sector.

March 2010: **Labour Government Budget announcement** of investment of at least £75 million in youth services, business literacy and a Social Investment Wholesale Bank "if funds available".

April 2010: **Social Investment Task Force Report "Social Investment : Ten Years On"** – states that the Social Investment Bank is crucial to improving the position of challenged communities in the UK.

July 2010: **Speech by Prime Minister David Cameron**– *"The big society bank will ...make new finance available to some of our most dynamic social organisations." "As a wholesale organisation, the Bank will invest in financial intermediaries in the social investment market, who in turn will increase access to finance for frontline, social organisations".*

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[27] 1977 US Community Reinvestment Act.

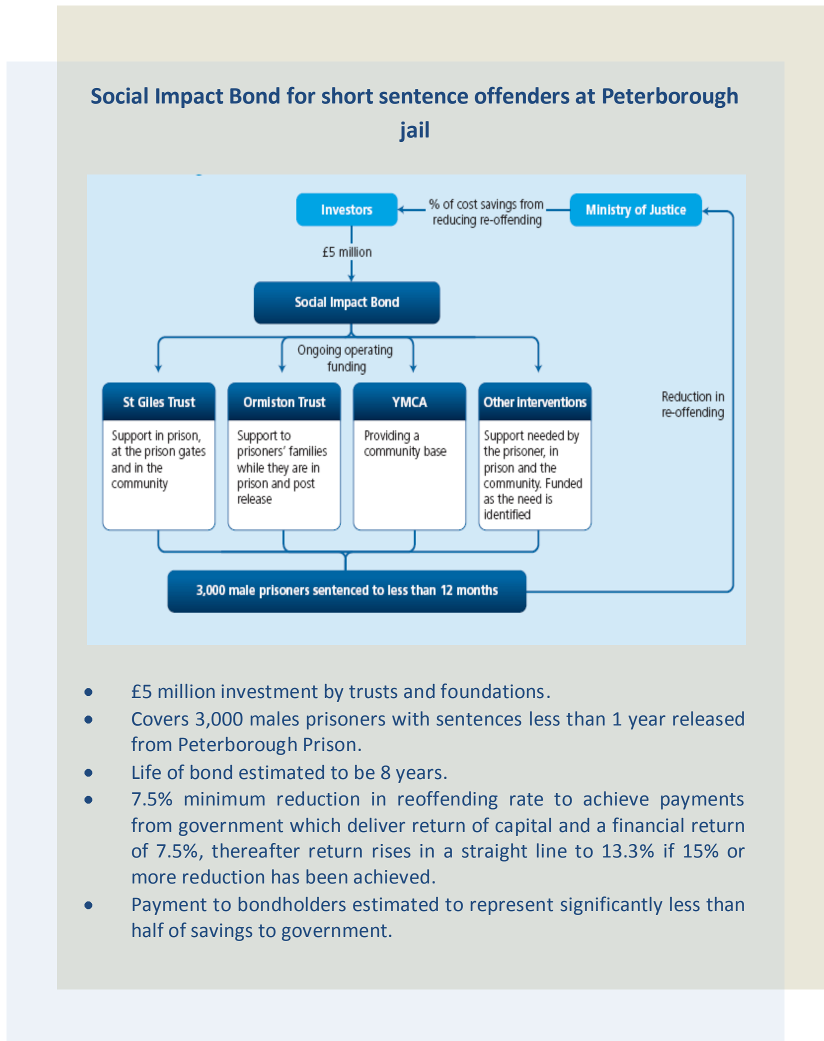
[28] "Social Investment: Ten Years On", Social Investment Task Force, April 2010.

[29] Social Finance "Towards a New Social Economy", March 2010.

[30] www.charitycommission.gov.uk/RSS/News/pr_investment_matters.aspx

inefficiency in funding and capital formation. Social returns do not attract capital in the way that financial returns do and such an organisation is required to act as a financial engine for the social sector, attracting capital by blending social returns with financial returns and tax incentives.

In the UK, the Commission on Unclaimed Assets (CUA)[31] and the Social Investment Task Force forcefully argued for the creation of a "social investment bank", capitalised from the pool of unclaimed assets languishing for more than fifteen years in bank accounts and building societies. Now, provisionally named the Big Society Bank, this initiative has strong backing from the Coalition Government, with the Prime Minister pledging that "every penny of dormant bank and building society account money allocated to England" – estimated by the British Bankers' Association to be £400 million - £500 million (but potentially considerably more according to the CUA) - will be used to capitalise the equity of the organisation, which will seek to play an investment banking role for the social sector rather than be a bank that is licensed to take deposits[32].



Social Impact Bond for short sentence offenders at Peterborough jail

- £5 million investment by trusts and foundations.
- Covers 3,000 males prisoners with sentences less than 1 year released from Peterborough Prison.
- Life of bond estimated to be 8 years.
- 7.5% minimum reduction in reoffending rate to achieve payments from government which deliver return of capital and a financial return of 7.5%, thereafter return rises in a straight line to 13.3% if 15% or more reduction has been achieved.
- Payment to bondholders estimated to represent significantly less than half of savings to government.

Such a "Big Society Bank" could provide equity, loans and guarantees. It could be a cornerstone investor. It could facilitate innovation by supporting the development of new financial instruments and raising capital to fund social intermediaries. And it

[31] The Commission on Unclaimed Assets was established at the initiative of the Scarman Trust in November 2005 following an agreement between the Treasury and the UK banking sector to release funds from UK accounts dormant for at least 15 years. The Commission drew together a group of experts from the banking, finance, consumer protection and third sectors. Together with government observers, it sought to ensure that dormant account legislation creates maximum public benefit by providing the catalyst for many consumers to be reunited with their lost money and putting the remaining dormant funds to use for the public good.

[32] Rt Hon David Cameron MP, Prime Minister, speech given in Liverpool, July 2010. http://www.number10.gov.uk/news/speeches-and-transcripts/2010/07/big-society-speech-53572

could assist social sector organisations build up their balance sheets and cash flows in pursuit of their social mission.

A crucial role for the Big Society Bank is to devise new instruments for social investment, which is the third requirement for change. Social Finance, a nascent social investment bank that grew out of the work of the CUA and the recommendations of the Social Investment Task Force, has devised and issued the first Social Impact Bond (SiB), currently being piloted with the UK Ministry of Justice to reduce recidivism by prisoners released from Peterborough jail. SiBs provide an innovative mechanism for payment by results, whereby private-sector investors can fund not-for-profit social ventures whose intervention results in a social benefit as well as a financial saving to the state. A social venture that reduces very high reoffending rates, for example, would save money by reducing the prison population and the cost of the justice system.

The financial return on investment in an SiB varies directly according to the social benefit achieved. The first SiB, issued in September 2010, focused on re-offending because the metrics in re-offending are clear and it is possible to design a control group against which to measure performance. Payments are made to investors in the SiB only in the event that the interventions of the not-for-profit enterprises they fund deliver a measurable reduction in re-offending. The target population comprises 3,000 prisoners due to leave Peterborough prison over the next six years, at the rate of 500 released prisoners a year. A reduction in re-offending of 7.5% over the life of the programme would trigger a return on capital in real terms. A sustained 10% reduction over the life of the programme would deliver three payments - after each two-year cohort of 1,000 is released - and result in an annualised return of 7.5% pa. Higher reductions still in the rate of re-offending would deliver yet higher returns to investors, subject to a maximum payment to investors over the life of the programme if a reduction of 15% or more is achieved. This would be equivalent to a return of 13.3% pa over the life of the programme. If the measured improvement is less than 7.5% over the life of the programme, then investors lose their capital and, in effect, will have made a philanthropic contribution.

Social Finance believes that, based on the past performance of the three not-for-profit organisations that will initially receive funding from the SiB, investors have a good prospect of achieving a 7.5% - 13.3% pa return.

The control group against which performance is measured and payments are made comprises a sample of short-sentence male prisoners ten times the size of the cohorts at Peterborough, released in parallel. These prisoners do not benefit from the interventions and are matched on a range of variables, including age and criminal history, to be as similar to the Peterborough group as possible.

According to Social Finance estimates, the likely payments to investors will represent significantly less than half the expected cost-savings to the criminal justice system arising over the longer term from the reduction in re-offending.

This appears to be the first time that a financial instrument has been used to enable social entrepreneurs to raise capital and to earn a return that is directly based on the social outcome they have achieved. It could be a momentous innovation. Already it has attracted attention in the USA, where Social Finance has established with US partners Social Finance USA, a sister organization based in Boston. President Obama recently announced that his administration is to set aside $100 million for seven pilot programmes using social impact, or pay-for-success, bonds.

Beyond raising finance from the huge pool of foundation assets, it is easy to see how issues of such bonds could be adapted to the needs of different institutional investors to increase the demand for them. For example, introducing a first-loss provision that would be borne by government or charitable institutions could help to make SiBs appropriate for pension funds and provide social entrepreneurs with access to the $23 trillion of pension fund assets in the world[33].

SiBs effectively link social enterprises with the capital markets. Once a social enterprise has established performance metrics, it can go to the capital market to raise funds. The fact that the first SiB was placed among twenty investors, including about a dozen UK foundations, the Rockefeller Foundation and the KL Felicitas Foundation from the USA, and the charitable trusts of five, high net worth individuals and two wealth management organisations, shows that it is possible to create a market for syndicating such bonds and attempts are already being made to create underwriting pools for their issue. Creating a large market in which syndication is possible requires clarity on social outcomes, transparency on social-performance metrics and independent research which validates the propositions. We are at the beginning of the process.

The SiB rewards social entrepreneurs for their success in delivering beneficial social outcomes. Importantly, it also eliminates the state's risk: government only pays out if the targeted level of desired objectives has been achieved. SiBs act as hybrid securities (equity on the downside and variable return bonds on the upside). They are likely to work best when applied to important social issues affecting clearly defined target groups, where effective not-for-profits are or want to be active, with interventions that are clearly understood and whose impact can be measured against a reliable control group.

The incentive to use them exists wherever the cost of intervention is significantly less than the public-sector saving they deliver. In addition to recidivism, such situations might include the drop-out rate in schools, improved academic achievement at various levels of education, improved rehabilitation rates from drug dependency, appropriate medical treatment at home rather than hospital, help to the disabled to enable their entry to the workforce, homelessness, helping the elderly to live at home rather than move into state-run homes, and the reduction in the number of children in care[34].

In order to power the social sector forward, we also need new modes of co-operation with government to boost the sector's capacity. For example, the government could co-invest alongside impact investors and social entrepreneurs. British impact investor Bridges Ventures, for example, whose funds combine financial and social goals (such as investing in poor areas and in businesses that promote health and education), has raised more than £150 million for social investment - and aims to double this over the next few years - as a result of matching finance of £20 million provided in 2002 to its first fund by the government[35]. A variant would be that government would incentivize charitable funds to guarantee a portion of a given social investment so as to make that investment more attractive to financial investors. This would help mobilize the assets of charitable foundations and trusts,

[33] Towers Watson 2010 report on global pensions.

[34] Social Finance: "Towards a New Social Economy: Blended Value Creation Through Social Impact Bonds", March 2010; and "Social Impact Bonds Unlocking Investment in Rehabilitation", September 2010.

[35] www.bridgesventures.com/our-funds

which, as noted earlier, total more than $600 billion in the USA and £95 billion in the UK, in direct support of social missions.

Bridges Ventures

Dedicated to proving that entrepreneurship knows no social or educational boundaries, Bridges works with entrepreneurs to create businesses that combine social impact, environmental sustainability and commercial opportunity to drive investment returns. Bridges manages private equity funds and a property fund focused on the most deprived 25% of the UK, as measured using the Government's Index of Multiple Deprivation (IMD). Bridges also manages a Social Entrepreneur's Fund. Total assets under management are more than £150 million. The estimated net IRR on the first private equity fund (2002) so far looks set to exceed substantially the 10% - 12% originally targeted by this fund. Examples of positive social/environmental outcomes from private-equity investments are:

Company		Impact
	Affordable health and fitness clubs	Provides access to affordable fitness facilities for 50,000 members, of whom 35% or more have never joined a gym previously. Sites built to the highest environmental standards and ten of eleven sites are based in under-served areas.
	Telephone-based utility price comparison service	Created over 80 new jobs – majority women and ethnic minorities. >60% of staff came out of unemployment. Has raised over £0.5m for charity partners. Founder and CEO was a single mother of three who left school at sixteen. With her business partner she turned £300,000 into £22m in three years.
	Vocational skills training provider	Mid-career retraining in high-demand professions such as plumbing and green energy with 95% pass rate. The service includes careers advice and significantly increases employability for students, a number of whom have previously been made redundant.
	Serviced offices in inner-city areas	Fosters entrepreneurship, providing affordable accommodation to 345 SMEs based in underserved areas. Employs top environmental standards and works with local charities to provide education on sustainable business.
	205-room price-competitive hotel in under-served area close to the City of London	Project part of the regeneration project for Shoreditch, The Hoxton runs an apprentice scheme offering placements to unemployed young local residents and sponsoring their education at a local college.

Finally, the mindset of the social sector needs to embrace output-based and market-based solutions in order to make it possible for foundations to use their balance sheets to achieve social aims, rather than simply funding grants out of revenue. This would start a process of providing entrepreneurs with access to the long-term funding required to build scalable, sustainable organisations. Harvard professors Kaplan and Grossman have noted that "most nonprofits attempt to keep their administrative expenses low and focus narrowly on short-term financial performance. As a result, they fail to build capabilities in strategy, leadership, fund-raising, performance measurement, and organisational development"[36]. This is sometimes imposed on them by philanthropic funding that insists on money reaching beneficiaries in the most direct way possible and precludes structured, long-term commitments necessary to build and finance growing organisations.

It is very significant that when Social Finance raised the first SiB of £5 million from charitable foundations and others, most of these investors, rather than treating the money as a grant, held it on their balance sheets as an investment. This demonstrates the interest in bringing charitable assets to support the development of the social sector alongside charitable grants.

Of course, achieving the transformation advocated here will not be easy. Social entrepreneurs manage two bottom lines, one social and one financial - and often three if they target environmental issues as well. This requires special skills, which, in turn, suggests the need for special training and experience. But the development of SiBs by Social Finance, which has only been in existence for three years and which today counts a team of twenty-two people, is itself evidence that, if you bring together talented, highly-motivated people who are versed both in finance and in the treatment of social issues, then significant innovation will result.

The deployment of SiB capital is akin to hands-on venture investing. Venture capital firms support their investments with sector expertise. Social Finance, which raised the first SiB, has brought in-house expertise in recidivism to bear in supporting the specialist not-for-profits that will deliver the proposed interventions with Peterborough's 3,000 released prisoners, in the same way that a VC or Private Equity firm would help an investee company. This is crucial to give investors confidence that the right blend of social and financial returns will be delivered over time.

Will such social enterprise render philanthropy obsolete? No. Some part of the philanthropic spectrum will be directed to impact investment but philanthropy as a whole will, if anything, have an enhanced role by virtue of its new ability to attract investment capital. Philanthropy is a precious resource, as any comparison between the size of government spending, capital markets and philanthropic assets would show. Any philanthropic assets donated to fund a solution that an impact investor could fund instead would be wasteful. There are many situations in which the philanthropic approach will always be more suitable than the impact investment approach: for example, where no clear social performance metrics can be applied, where community organisations are small and local, where the risk is too high or where the financial returns are too low for investors. In the arts, which have long depended on philanthropic contributions, social benefit is mostly unquantifiable.

Philanthropy can also help leverage in capital. In the UK, the St Giles Trust, one of the recipients of the first SiB, found that it needed to build up its organisation to be

[36] Kaplan and Grossman, Harvard Business Review, 2010, pp 117.

able to manage a programme of appropriate size. Here was a clear case where a layer of philanthropic grant-funding (in this case from Impetus, a UK venture philanthropist akin to New Profit in the USA) to build the organisation helped attract social investment from the capital market. Similarly, philanthropy can help at the start-up phase. This plays a similar role to the "friends and family" funding so typical of start-ups in the commercial sphere.

One of the prospective benefits of impact investment and social enterprise will be recognition of the value of hybrid business models, combining financial and social returns. In the venture-capital industry, it is understood that an investor will provide start-up capital to an enterprise while it refines its business model before a different funder can take it to scale. Similarly, in the social impact sector, an enterprise might require subsidy until the entrepreneur can refine the social business model or until the enterprise can generate sufficient cash flow. In the latter case, the enterprise might not require full subsidy but nor could it sustain market rates of financial return.

We should also bear in mind that there will always be initiatives at the local level working to engage the community in dealing with social issues. These groups, whose mission is often defined by their locality and which therefore have no ambition to scale up, should be encouraged by government, using accessible incentives and direct support, to continue in their important work.

Will social enterprise replace government programmes? No. Social enterprise and impact investing could reduce government expenditures while at the same time making social investments more efficient. But the task of providing a safety net for all citizens is surely too vast to be taken on entirely by social enterprise and the social sector. As GIIN has noted, it is not "a silver-bullet solution to poverty, environmental degradation, or other global challenges"[37].

Is then the role of social enterprise solely to fill some of the gaps in current provision? Again, no. Although such an ambition would be entirely worthwhile, social enterprise and impact investment could do much more: they could dramatically change the mindset and role of the social sector in the way that venture capital and business entrepreneurship did in mainstream business in the 1980s and 1990s. As *The Economist* recently noted, the idea is "to transform the way public services are provided, by tapping the ingenuity of people in the private sector, especially social entrepreneurs"[38].

How likely is it that such a transformation into a powerful "social impact sector" will be achieved?

First, let's remind ourselves that all new investment products begin without a track record and with a very limited pool of available capital. They have to create their own market. We know that, so far as entrepreneurs are concerned, the supply of money creates its own demand, and in the debate about capacity-building and the flow of capital – a debate akin to the conundrum about whether the chicken or the egg comes first - the answer is always that both must happen at the same time. Other new forms of investment, including venture capital, private equity and hedge funds - and, more recently, micro-finance - have successfully been built from lowly beginnings into significant new asset classes in a relatively short time. There is a need and an opportunity for impact investments to do the same.

[37] Open Letter, Global Impact Investment Network (GIIN), December 2010.
[38] The Economist, "Let's Hear Those Ideas" August 12, 2010.

There is no doubt about the scale of the opportunity. In its recent report, JP Morgan looked at impact investment in five sectors – health, education, housing, water and financial services – and concluded that "in aggregate, across five sub-sectors, we estimate a potential over the next ten years of profit ranging from $183 billion to $667 billion and invested capital ranging from $400billion to nearly $1 trillion"[39].

Michael Porter and Mark Kramer have recently discussed the need to reinvent capitalism by integrating social value into the corporate mind-set[40]. Bill Drayton and Valeria Budinich have proposed that there be collaborations between corporations and what they call the citizen sector to create hybrid value chains to "remake global economies and create lasting social change"[41]. The approach advocated here is complementary, harnessing entrepreneurship and the capital markets to help resolve social issues. Given the size of the opportunity, we should be looking for a step-change in social entrepreneurship, led by innovative organisations that have the ambition to scale up, implementing new approaches adapted from the private sector.

The social sector covers a whole spectrum, from philanthropic donors and not-for-profit service providers at one end, to for-profit social enterprises at the other. It comprises millions of people and hundreds of billions of assets. The new wave of social enterprise and impact investment is about to transform it and turn it into a more powerful social impact sector. The wave is building, just as the business enterprise and venture capital wave started building in the USA in the late 1960s. The conditions are favourable for this wave to sweep across the world. Everywhere, government resources are failing to keep up with increasing social need. In many countries, the social fabric is coming under serious strain.

It is not just the established stars of earlier generations of entrepreneurs and investors, such as Bill Gates, Warren Buffet, Pierre Omidyar, Jeff Skoll, Chris Hohn and Michael Dell, who want to help. A new generation of entrepreneurs is coming forward eager to make a social impact. Hitherto, we have sent our brightest business graduates into a world where they have to make a career choice between mainstream commerce or not-for-profit social commitment. Not any more. Young social entrepreneurs will, with appropriate enabling legislation and regulation, take advantage of new instruments to access the capital markets; apply private-sector investment and management techniques to social enterprises; and use private-sector standards of performance measurement.

Importantly, impact investment is not the preserve of major financial institutions and foundations. Family offices can embrace their historic role of funding the early phases of emerging asset classes. Private foundations can play their part in persuading conservative investment advisors of the value of impact investment. Private banks can help show how impact investing provides a link to reconcile conflicts between older family leaders and their more impatient children. And, in the USA as well as in the UK, there is an important role that owners of Donor Advised Funds can play by challenging their wealth managers to provide impact-investing opportunities for the assets they have already committed to charitable purpose.

[39] JP Morgan "Impact Investments: An emerging asset class", November 2010.

[40] Porter and Kramer, Harvard Business Review, www.hbr.org/2011/01/the-big-idea-creating-shared-value/ar/1.

[41] Drayton and Budinich, "A New Alliance for Social Change", Harvard Business Review, September 2010.

With the support of government, the philanthropic sector and the capital markets, social entrepreneurs and impact investors will usher in a new, powerful way of dealing with social issues that will help stabilise society and improve the economy. What entrepreneurship has done for business in recent years, social entrepreneurship can now do for society.

Ends