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Research Report

Frontiers of sustainable finance in Europe: The social impact bond

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Policy Letter No. 24

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Frontiers of Sustainable Finance in Europe: The Social Impact Bond

Ester Faia

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Financial innovation is not always about speculation. Sometimes financial innovators help society to advance the quality of life and provide remedies for social problems. One such idea evolved in 2010 in the UK: the social impact bond. This is a special type of bond in which multiple parties are involved. The purpose is to provide long term funds to projects with a social impact. In times of crisis, governments lack funds precisely to prevent the social consequences of recessions: namely poor health, low schooling rates, increasing criminal activity, youth unemployment, children and women protection, etc.

In the UK, the debate about funding social projects led to the creation of a special type of intermediary, the Social Finance Ltd.. This institution raises funds to finance government projects through bonds whose returns are paid out only when social improvements are achieved. The intermediary (in this case Social Finance Ltd.) has the opportunity to collect funds from a large platform of investors and in many cases has the ability to judge whether the project has achieved results. In case of social projects, the evaluation of results can be difficult, but quantitative indicators can be found. For instance, the first of such projects financed in the UK was the rehabilitation of offenders for crimes below 12 months of imprisonment. Successful rehabilitation is beneficial to society not only due to an improvement of the quality of life, but also due to a reduction of government spending for public prisons. The project will be judged successful if in 2016 the criminal rate of prisoners under the program will go down by 7.5%. In this case, investors, who have subscribed such bonds, will receive a return. If the project is not successful, the bond will not pay returns.

This type of financial instruments quickly reached also the US (the Obama administration is strongly encouraging their use), where they are referred to as Pay for Success Bonds. An institute at the Kennedy school (The Harvard Kennedy School Social Impact Bond Technical Assistance Lab) is conducting research on how governments can foster social innovation and

is providing pro-bono technical assistance on how governments can implement efficiently the Pay for Success Bonds.

Little has happened so far in Europe in this regard. Italy is one of the exceptions: in 2011 a large banking group started to issue social bonds (the Italian equivalent of social impact bonds) to finance projects in the third sector. This form of finance is now well established within this group and is spreading to other banks that propose ethical finance. A first initiative has been started in Germany with a project of the Benckiser-Stiftung für Jugendförderung, which aims at bringing young people with bad school results into the job market by issuing a bond called Juvat (in Latin this means “it works”).

The consequences of the crisis on the social relationships have been severe throughout Europe: social problems are largely responsible for increased welfare spending and reduced growth. Not surprisingly, a large part of the calls for the Horizon 2020 grants is devoted to such issues. The European Union should develop an equivalent to the British Social Finance Ltd. Such an institution could be an intermediary that would go beyond boundaries, devoted to improving social conditions in a society with increasing inequality, by using financial instruments that provide the right incentives. Fostering social bonds and a European wide market for them could be another, not less important task, of the new born Banking Union.