A Financial Perspective on Social Impact Investment

Many 3rd sector organisations are currently facing their own crisis, brought on by persistent turmoil in financial markets and reduced government funding opportunities. The principal benefit of social impact investment is that it provides an alternative funding stream for these organisations, enabling them to continue to provide much needed services to our communities. Those who think that this is a scheme cooked up by the current government in order to plug a public service gap created by their spending cuts should think again; whist the opportunity to invest on this basis might be new it is not a creation of the 'Big Society', though it conforms to similar principles.

What is a social impact investment?

In principle social impact investment is quite simple. A pool of private capital is made for the purpose of funding a social project with quantifiable objectives, delivered over a fixed term. As the objectives are met, the project organisers claim money back from government based on the principles of future or associated cost reduction. (The same principles of outcome based payments underlie privatised welfare to work schemes such as the Work Programme.) The outcome payments received are used to provide a return to the initial investors.

Why use social impact investments?

Social investments may provide a way in which people can help use their accumulated capital to achieve something other than a purely financial return. Much research now points towards inequality as the biggest cause of social deterioration, so looking to use private capital to fund programmes for those less fortunate seems like a good way to help improve the situation for everyone. Also, with global financial markets experiencing continued volatility, such an investment might be considered a viable compliment to a traditional investment portfolio. Conventional investments have their benefits, after all they underpin the very foundations of our economy, and without them there would in all likelihood be no money to invest in social impact schemes. With the advent of social impact investing surely here should be something which all investors are racing to sign up to, at least with an element of their capital?

What is wrong with social impact investing?

Disappointingly, there are a number of reasons why investors are possibly reluctant to participate. As any good financial planner will tell you, no investment comes without risk. Even holding your money in a bank account is subject to some degree of risk. If someone was to invest in a social impact investment, what would be the risks involved? Unfortunately, for something which has already received a degree of government support, the risks to investors are quite high.

Firstly, there is the possibility that the social objectives triggering outcome payments might not be met. If this happens investors might not get the return they were hoping for or, in extreme cases, nothing at all. After all, if the investment fund has used pooled capital to provide a service there little chance of there being any money left; we are not talking about a company which could be sold off, or have its tangible assets realised for the purpose of returning some capital to the investors. Anyone entering the capital pool is therefore faced with the possibility of getting nothing back if the scheme is unsuccessful.

There are other differences to the risk of investing in the shares of a traded company, or traditional unitised collective investment. In many of these if you need to get out you can, as there exists a secondary market for the investments. What we are looking at here is an investment which would tie you in for a number of years, so as well as a capital risk there is also a liquidity risk.

Herein lies one of the main problems of social investment vehicles in their current form, if you combine this level of capital risk with a long term and no possibility of access to capital you are not looking at a product which is suitable for an average investor. This kind of structure is often seen in the financial sector but usually carries the restriction 'for sophisticated investors only' and no, they don't mean it is only good for those who would be more at home at Glyndebourne than Glastonbury.

There are many investments which might appeal to private individuals who qualify as sophisticated investors and these often carry special tax incentives for subscribing, such as investments in Enterprise Investment Schemes and Venture Capital Trusts. Unfortunately, it would seem that at present social impact investment carries no such tax breaks.

In addition to those risks already mentioned, it is worth noting that this type of investment is largely untried and the outcome payments model is something which has been largely confined to the welfare to work sector. The Peterborough project launched by Social Finance Ltd, is seen as a figurehead investment by those looking to raise funds for this type of scheme, yet we do not know how successful this scheme will be and, just as important as the social aims it intends to meet, will it be able to achieve a return on investment for its investors, either at the target rate or at all? Anyone who recalls the launch of the Peterborough scheme will remember that this was deemed to be a PILOT project by the Department of Work and Pensions (DWP). It has only been running since September 2010 and so it would be unwise to say that that any significant conclusions could be drawn from progress to date.

Overall, most investors would think twice about investing in something which requires a significant capacity for risk, tying money up for a number of years and is based on a model which has only been running on a relatively small scale for a limited period. Despite these misgivings however, this type of funding arrangement represents a significant opportunity for us to invest in the future of our country, to put some of our capital to good use in improving our collective future.

What can we do to correct this?

How do we approach the constraints which are prohibiting this funding model from becoming the success it could be? There are some avenues to be explored.

Investors will be concerned that the social impact targeted is achievable, otherwise the goals of both social and financial return are unlikely to be met. The use of a thorough and transparent vetting procedure should improve the overall proportion of successful schemes: those which are unable to prove their worth at a proposal stage are not given the opportunity to take unnecessary risks with investors' capital. The implementation of a standardised vetting procedure should be relatively easy to achieve, as government supply chain analysts will be pouring over the fine print in order to approve each scheme in terms of their suitability for outcome payments. Whilst Government is already taking steps in this direction in the implementation of the DWP's Innovation Fund, it should not be forgotten that the opportunity for delivery on areas outside of the DWP's remit will exist: local and devolved governments will have their part to play. A worthwhile step would be to standardise and make public the guidance which will be used for approval, with a clear grading system for successful applicants.

The evaluation stage of the process to implement a programme is undoubtedly going to eliminate many worthwhile projects from the potential pools, but not all social programmes are appropriate for this type of funding model. Other alternative funding streams may develop which would help these get off the ground and there is nothing to say that these will not be based on private financing.

Investors, having been made comfortable in terms of the reliability of the programmes, should be able to call upon a greater deal of support than the average unregulated investment scheme. The issue of a nil return is likely preclude those of a more risk-averse nature, or indeed many of a more speculative nature considering the other associated risks. Given the government oversight of the initial tendering process it is not inconceivable that government could underwrite at least a proportion of the capital which is being put at risk as part of that arrangement. This is a lot to ask and it might make the tendering process more strenuous but the benefits are clear. It would give investors confidence that they are buying in to something which has a real chance of succeeding whilst providing the comfort of a government backed 'stop loss' if the assessment of the viability of the programme has been too optimistic. This kind of protection does not come cheap, but the sacrifice of some return might be worthwhile.

Government underwriting is not the only option: Big Society Capital and other financial institutions may have the capacity to provide a similar facility.

Regulation and the regulator’s approach to these types of investment should be made crystal clear as the provision of ‘corporate finance’ in this context should not be something which is exercised with light-touch regulation or exist outside the regulatory framework. Clear and specific guidance from the Financial Services Authority is needed. Closer regulatory supervision might make these investments more palatable to more than just private investors. The Charity Commission has recognised these types of investment but has not smoothed the way for charities to invest, something which might have helped progress during these early stages.

In order to rectify the issue of tax benefits for investing on this basis some consideration might be given by HM Treasury of the potential tax benefits which could be awarded to this type of investment.

Social impact investments represent a huge leap forward in terms of providing a financial incentive for the facilitation of social returns and the opportunity they represent for improving our social landscape is one which should not be passed by. It is possible that organisations will secure capital for investment in the current form. Were there to be a concerted effort to reduce the significant risks faced, even at the expense of some of the financial reward, there would likely be some improvement in appeal and suitability for a wider audience.