EVALUATION OF THE INTEGRATION BETWEEN CORPORATE AND FINANCIAL PERFORMANCE: THE SOCIAL IMPACT BOND FINANCIAL INSTRUMENT

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Abstract

The social impact bond (SIB), at the present in Italy, is a financial instrument issued by a bank to support social initiatives in which the subscriber will receive a limited financial return on investment. As part of that performance, the social return for the community is considered as an integration of the financial performance that will replace a part of the interest rate. The first experience in Italy is represented by a bank that has issued 45 Social Bond for 472 million euros. The research analyses, on the basis of the characteristics of the third sector in Italy, with particular reference to the financial weakness of the sector, the possible impact on the financial management process in the social enterprises by the use of SIB. Moreover, we would demonstrate that, with a well-conducted cost-benefit analysis, it is possible to construct a hypothesis of SIB in which the repayment is based on market rate. In particular, is proposed the development of a SIB with the objective of formulating hypotheses of response to the innovative following questions: Given certain cost drivers, what social outcomes would generate savings for the state budget able to fully repay the fixed costs of the SIB, to give a percentage of the benefit to the government and to ensure the repayment to investors? How to identify the timing of cash flows in order to structure a potential internal rate of return objective satisfactory for investors? Due to the lack of already developed case studies, with the technics of the business plan, we analyse the impact of SIB on social and financial performance, both from the point of view of the Public Administration and of the social enterprise, in a project of social housing introducing a remuneration rate at market level. The development of the project shows that, with the integration of the private and public perspective, it is possible to improve the social and financial performance offering an adequate interest rate and, moreover, without limit the hypothesis of SIB underwriting to the philanthropic institution.

Keywords: Company Performance, Financial Performance, Social Issues, Social Impact Bond

1. INTRODUCTION

The financial management is a critical element in all types of enterprise. The characteristics of the financial instruments – its typology and date of expiration – are fundamental to obtain a long run financial equilibrium. It is known that a temporary financial disequilibrium could not weaken the economic equilibrium; nevertheless, a bad financial management in a long period damages the economic performance. An enterprise characterized by economic balance should not have too much difficulty in finding financial resources. Nevertheless, if the financial imbalance became persistent (this assumption is realistic for a social enterprise where there are the prevalence of activities with public entities), the average cost of such liabilities increases with the increase of liabilities. In a social enterprise the margin income is usually not large, and in the long run, the excessive weight of financial charges could lead to an economic imbalance. Moreover, a social enterprise is featured by exchanges with the market; so, it is necessary a good management of the liquidity in order to not compromise the exchanges with the suppliers (Pathirawasam & Wickremasinghe, 2012; Ferrone, 2014).

The finding of resources to activate the operative cycle requires a hard attention on the amount and typology of such resources, in order to support correctly the process of acquisition of the current assets. These assets are indispensable for the maintenance of the quantitative and qualitative level of the supplying services. So, the quality of the financial management is considered more important in the social enterprises, whereas the quantitative and qualitative level of the offer may increase the level of social welfare (Tuccillo et al., 2011).

In social enterprises, the attention of the management is often addressed to the social sphere, with an insufficient entrepreneurial culture, and the lack of financial management knowledge. The consequence of such insufficient financial culture is, according to Pace (2004), the absence of the non-profit organizations of a specific function dedicated to the financial management.

A not very careful financial management could weaken the social enterprise in a context in which the traditional financial intermediaries, and particularly the banks, consider more uncertain the solvency of the social organizations; the worse profile of risk assigned to these organizations is translated in rationing of the credit with the increase of the interest expenses.

According to Manelli (1996), the banks assign a worse level of risk to the social cooperatives due to:

- a strong dependence on the human factor, above all for the operating activities;
- the insufficient presence of fixed assets, to be used by banks as real guarantees;
- the lack of a detailed planning for the investments, with the forecasts of the economic and productive opportunity derived from such investments.

From the public side, the current approaches to government funding of social services create significant barriers to innovation. Funding streams tend to emphasize inputs rather than program objectives and are often overly prescriptive, requiring grantees to use a particular delivery model. In many cases, program outcomes are not rigorously assessed, allowing unsuccessful initiatives to persist for years. Meanwhile, the public sector is slow to adopt new program models, even those proven to be highly effective. There is no systematic process through which philanthropically funded interventions with demonstrated success receive the government funding necessary to expand. Investments in preventive services can be particularly difficult to finance because the funding streams that support such services are often in different accounts from the programs in which the cost savings accrue (Liebman, 2011).

In particular, the paper structure provides an introduction, where the financial weakness in social enterprises is examined and the opportunity to use new financial instruments is discussed. Subsequently, the literature review on the relationship between sociality and value creation is recalled and the characteristics and advantages of SIB are exposed.

Finally, the lack of already developed case studies has imposed the reference to the case study technique and the exclusion of comparative case studies. The latter would have allowed a comparative examination of the results emerging from a multitude of cases, naturally with the aim of achieving generalizing cognitive objectives in relation to a pre-selected population; however the case study allows an exploratory approach and the adoption of a deductive-inductive methodology, based on a continuous movement between the theoretical and the empirical dimension. In fact, this research is generally based on the dynamics of continuous interaction among the theoretical frame of reference, the empirical plan and the case analysis.

2. LITERATURE REVIEW

Social investment was traditionally considered by private company as a non-productive investment, as an expenditure of defensive nature, planned to waste resources without producing new wealth, to protect, on the one hand, the corporate image and on the other, the public interest (Agliata et al., 2014; Zamagni et al., 2015). However, nowadays, the public interest cannot be a goal just for Public Administration; each company should integrate a strategy of social responsibility in management decisions (Del Baldo, 2015). On the other hand, social investment can produce also financial value (Tuccillo, 2010; Koldovskyi, 2015).

The economic, social and environmental dimensions, mutually interconnected, therefore, should guide management decisions towards the achievement of the objectives through the expansion and the consolidation of competitive advantage, favouring the long-term perspective (Elkington, 1997; Willard, 2002).

Social responsibility should be considered as deeply linked to the development of the company. A socially responsible company has the task of identifying the legitimate expectations of all the stakeholders and make them a substantial part of their own strategies (Voorberg, 2014). In the long term, the economic social and environmental outlooks must be considered mutually entwined; one cannot be separated from the other without risking compromising the sustainable development of the corporate organization (Grieco et al., 2013).

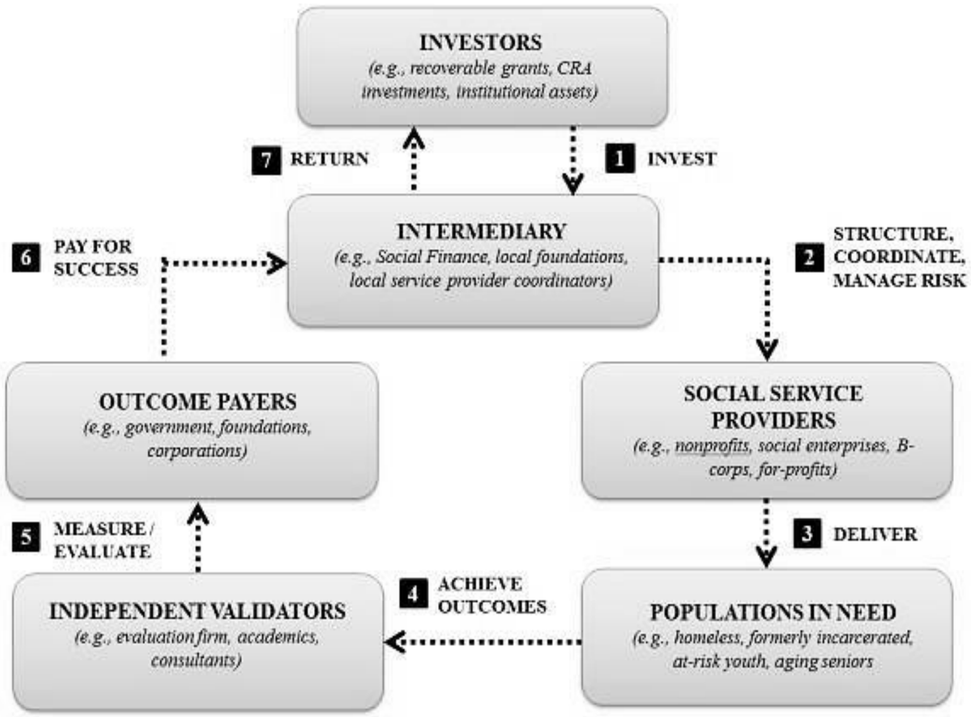
For the company, being able to understand and consider the link between Corporate Social Responsibility and creation of value, creates some problems concerning, not only strategic orientation and formulation of management decisions but also analysis and evaluation of expenditures which are not considered investments so far (Arru & Ruggieri, 2016). For it, to summarize, investing in the creation of stable and profitable relationships with internal and external parties interested in its activities, is a strategic choice enabling the achievement of lasting stability (Dasuki et al., 2016).

The tools which can enable leaders to create public value by bringing together the best that the public, private and non-profit sectors offer are at the top of the policy agenda in countries all across the world (Andrews & Entwistle, 2010; Jooste, 2016).

Taken in combination, the strong mandates of public sector organizations, the flexibility of private firms and investors and the community orientation of non-profits offer the prospect of the development of innovative solutions to these seemingly intractable problems (Warner, 2013).

Social impact bonds (SIBs) is a form of outcomes-based contract between public administrations, non-profit services providers and private investors, in which financiers provide upfront funding for improving specific targeted social outcomes. It tries to attract private investment to social programs by paying a market rate of return if predefined outcome targets are met. The integration of philanthropy, venture capitalism, performance management and social program finance create an innovative new mix (Ben Soltane, 2012):

Figure 1. The social impact bond (SIB) mechanism



Source: (OECD 2016)

SIBs monetize benefits of social interventions and tie pay to performance, limiting governmental control once the contract is designed. Obviously, the idea behind a social bond is that private investor could be attracted to invest in social fields in which they can have a positive pay off; the successes must be carefully measured and monetized to allow the use for structure the private investment (Burand, 2013; Fraser, 2016).

SIB could be considered as an emerging innovation in cross-sectoral coordination, which brings private sector investment into highly contentious and complicated areas of social policy. The private investment in physical infrastructure projects is becoming relatively common across the world (Hodge & Greve, 2005). SIBs could be considered as a significative variation of those type of investment, as an extension to create private finance mechanism for support social services, in which the private financiers focus on the potential (targeted) reductions in the future public expenditures due, for example, to the lower rate of recidivism (prisoners programs), school failure (children programs) and welfare use (homelessness program) as a result of increased investment in preventive social programs (Cooper et al., 2013).

From the perspective of the private sector, it is unlikely that capital market will provide significant amounts of equity for social ventures. Probably the SIBs may be a new form of venture philanthropy rather than a new form of private equity investment (Belinsky et al., 2014).

In synthesis, a social service organization needs to raise capital for operating expenses, so it issues bonds to private investors through an independent social finance entity. If the social service organization meets predetermined goals in a given time period, the government makes performance-based payments that can be used to pay a return to the investors. In theory, everyone goes home happy: The organization gets capital; the investor gets a return; society benefits from the service; the government avoids any potential risk and possibly saves money (Edmiston & Nicholls, 2018).

The best example to date is a prison program in the United Kingdom, where investors can earn a return of 7 to 13 percent if the recidivism rate falls by between 7.5 and 12.5 percent or more.

In the UK, some ministries (Justice and Home Affairs) and departments (Work and Pensions, Local Communities, Social Affairs) are implementing some innovative financing instruments to support social services, using the principle of "payment for results" (PFR). In 2010 the British government issued a social bond to find money to finance projects of reintegration for prisoners with sentences of less than 24 months in prison in Peterborough. Through a study has shown that prisoners who participated in these projects of re-employment had a recurrence rate of fewer than seven times the average. These findings have resulted in lower costs for the prison system and greater security for the local community.

In order to realize the project is determining the role of a financial intermediary specializing in Britain is Social Finance Ltd (British organization that develops financial products for social enterprises).

The project began with the intervention of the Ministry of Justice which gives the mandate to Social Finance to seek social bond underwriters to pay for the non-profit organization that is in charge of the project of re-employment. Annuities arising from social bonds will be paid by the Social Finance through the money that was saved by the State due to the achievement of social objectives of reducing the crime rate and recidivism.

This was followed by other cases, such as the SIB made in New York to reduce the recidivism rate of juvenile detainees and two programs of PFS in Massachusetts to reduce the crime rate among homeless youth; Australia has promoted SIB for a prevention project in deprived areas and with high rates of juvenile crime to support families at risk of social exclusion and to perform services for persons with disabilities (Ronicle, 2014).

3. THE DEVELOPMENT OF SIB IN HOMELESSNESS – A CASE STUDY

The British pilot project has not only attracted the attention of philanthropic investors but also of a multitude of developers over the past few years has brought countless applications of SIB model in order to test its structural strength.

The goal is to identify promising areas of application in which the SIB demonstrate the ability to effectively record social outcomes and to meet investors' expectations in terms of performance desired. To ensure the achievement of objectives, pilot projects should focus on those social programs that create savings for the government in excess of the cost of implementation of the financial instrument.

Is proposed the development of a SIB with the objective of formulating hypotheses of response to the following questions:

- Given certain cost drivers, what social outcomes would generate savings for the state budget able to fully repay the fixed costs of the SIB, to give a percentage of the benefit to the government and to ensure the repayment to investors?
- How to identify the timing of cash flows in order to structure a potential internal rate of return objective satisfactory for investors?

The analysis involves the construction of a SIB applied to a project of Social Housing in Italy. It was considered the financing of a project concerning the Social Housing because of the problem of homelessness presents:

1. *A great social impact*: according to a survey conducted by Italian National Institute of Statistic on the condition of people living in extreme poverty, homeless people in Italy in 2011 amounted to approximately 50,000 individuals (ISTAT, 2014). More than 40 % of them falls within the definition of chronically homeless lying in this condition for more than one year.
2. *High cost for the public budget*: more than half of homeless individuals frequently use institutional services. In the United States, where the homeless amounted to more than 500,000 individuals (HUD, 2010). According to research in the U.S. (McKinsey, 2012), they produce costs for programs on the public budget estimated at around 6-7 billion per year, with a per capita expenditure of 15,000. This level of expenditure is estimated with equal results from both programs devoted exclusively the homeless (such as the HUD, HHS, VA, etc.). Both those pertaining to the entire population (Medicaid, Temporary Assistance Program, SSI, etc.). The cost estimate made by the U.S. Department of Housing and Urban Development is much higher, ranging from $ 40,000 to $ 150,000 per year. In the city of Dallas, for example, the expenditure amounts to more than $ 100,000 per year for each homeless and includes health services, prisons and mental health care. In Britain, where the homeless are about 50,000 such as in Italy, the figure estimated by the government ranges from 24,000 to 30,000 pounds per year for single homeless; between 2010 and 2011 that resulted in cost over a billion pounds for the public budget. In Italy, by failing to provide official research, we decided to consider an amount of € 35,000 for each person living in the homelessness condition, more conservative than the U.S. data and closer to those of the UK.
3. *Evidence of effectiveness of social programs*: The Permanent Supportive Housing is a social program that is having amazing results in terms of outcomes (Elliott & Wilkins, 2010). The idea behind this is that homeless individuals are better able to receive care when you offer them a home – so-called theory's Housing First (Tsemberis et al., 2004). By offering the homeless a place to live on a permanent basis with a series of subsidized services they are able to live independently a more dignified life. The Corporation for Supportive Housing recorded in the last 10 years, the construction of more than 150,000 units of PSH in the United States; the measure has achieved a reduction of 45,000 in the number of chronically homeless individuals. In other words, about one-third of the chronically homeless to which assistance was provided through a program of PSH managed to avoid returning to a life of wandering on the street, stay in emergency centres and in the worst cases detention. An experiment done in the city of New York on approximately 5,000 chronically homeless identified thanks to the programs of PSH a 86 % reduction in the use of reception centres (so-called shelters) and 78 % in the use of hospital stay (Culhane et al., 2002).
4. *Sleight of production of social benefits*: the PSH program is able to produce benefits in the first year of use. Individuals, when they have a house to live in, have recourse to an extent largely reduced to

institutional services, creating immediate savings for the state budget.

As has been pointed out several times in the course of treatment, the effective development of the social program is critical to the success of the SIB. Service providers must be competent and structures with specific experience in the industry. The key factor is the competence of the local service provider who is knowledgeable of the specific circumstances of the territory in which it operates.

Turning to structural aspects of the model, the drivers of cost were summarized in only two categories: costs of incarceration, and medical and hospital expenses. The estimate, as already mentioned very conservative when compared to data from the United States, is instead aligned with the British data amounting to a total cost of € 35,000 per individual per year.

The outcome social objective, as shown in Table 1 is 80 %. In other words, that the SIB is successful it is necessary that 8 out of 10 individuals subjected to the interventions of the social program will not come back to use institutional services. The achievement of this result has a financial value in terms of cost savings in the order of € 22,400 per annum, considering a reduction of the public expenditures for people in the success of about 80 %. In another way, we suppose that in terms of public budget a subject involved still require health services but at a 20 % level than before its involvement in the program.

As a result, the achievement of outcomes goal every year for the reference population would record savings for the state budget measured in approximately 156,000 Euros. Over a lifetime of SIB (7 years) would be produced savings of approximately EUR 3,1 million.

Table 1. Input cost – benefits analysis

	Before SIB	*% success*	*% Cost reduction*	*After SIB*	*Annual individual cost reduction*	
Incarceration costs	€ 15.000,00	80 %	80 %	€ 5.400,00	€ 9.600,00	
Medical and Health	€ 20.000,00	80 %	80 %	€ 7.200,00	€ 12.800,00	
Total	€ 35.000,00	80 %	80 %	€ 12.600,00	€ 22.400,00	
Expected Outcomes			***Program Cost***			
Beneficiary	20				***Monthly***	***Annual***
Annuality	7		Housing rent and utilities		€ 700,00	€ 8.400,00
Programs	140		Care services		€ 400,00	€ 4.800,00
Annual individual cost reduction	€ 22.400,00		Individual program cost			€ 13.200,00
Total cost reduction	€ 3.136.000,00		Total program cost			€ 1.848.000,00

It is clear that the outcome set (8 out of 10 people do not return to use the services) are directly related to cost savings for the public purse and can be easily measured through comparison with a control group or with a historical average (benchmark) for the use of institutional services to serve as a baseline reference.

The cost of the social program per capita has been suggested in € 13,200 per individual, including in that amount the cost for rent house and utilities estimated to € 8,400 (700 per month), and cost for care services estimated to € 4,800. Considering the number of users to engage, 20, and the annuality, 7, the total cost of the program would amount to € 1,848,000.

With regard to the financial aspects, it has been suggested recognition of a fee to the financial intermediary and the independent external consultant to the extent of 2 % of the total program cost of PSH. Since the SIB is first and foremost an instrument of social impact, these parameters have been set so calmed compared to traditional values used by Private Equity Funds. As shown in Table 2, the total cost of the SIB amounts is approximately € 1,920,000.

Table 2. Cost – benefits analysis

Costs	*Amount*	
Individual program cost	€ 13.200,00	
Total program cost	€ 1.848.000,00	
Independent Expert (2 %)	€ 36.960,00	
Intermediary fee (2 %)	€ 36.960,00	
Total SIB cost	€ 1.921.920,00	
Public cost reduction	€ 3.136.000,00	
Net Saving	€ 1.214.080,00	
		Annual
Public quote	€ 242.816,00	€ 34.688,00
Private investors quote	€ 971.274,00	€ 138.752,00
Private return	50,44 %	7,22 %

Subtracting the savings produced by the SIB (over the 7 years of operation) the fixed cost of implementation of the social program you get net savings for taxpayers of about 1,2 million Euros.

For computational simplicity, it was assumed that these savings are split evenly on the interval of seven years in which the instrument is operating.

Using the upside leverage scheme, a margin of retention benefits to the government have been set by 20 %, in other words, of the 1,2 million euros of savings, the government returns to the ecosystem SIB only 80 %; and the possibility that this margin is reduced in relation to potential extra-yield products, i.e. the moment when the outcomes are exceeded. In this way, investors would benefit from the extra savings in the most beneficial way.

In this way, the production of the social impact objective would allow the SIB achieving an IRR of 7,22 % over 7 years; in other words, getting the outcome of 80 %, in a period of about 15 years the SIB would be able to offer the payback for investors, the coverage of fixed costs of implementation, and the margin of deduction to the government.

Given the substantial track record in terms of the effectiveness of the program PSH, a reduction of 80 % of the cost drivers is perfectly aligned with field studies.

Moreover, in terms of return, is possible to encourage state governments to make social impact bond tax exempt, in order to increase private financial interest (Dugger & Litan, 2012).

4. CONCLUSION

The social sector has until now largely dependent on the role of governments and traditional philanthropy. Without appropriate financial instruments, it is highly likely that in the future you do not manage to meet the growing needs of society.

The SIB provides the opportunity to revolutionize the financing of some social projects through private investment and reward programs that prove effective.

The analysis shows how the SIBs present a number of specific benefits and how the conditions of the market and the potential for them become a source of financing widely used for public utility projects.

In recent years, in particular, the financial world has witnessed the growth of interest and curiosity on the part of investors for the new instruments of Impact Investing.

The SIB is thus able to create a positive chain reaction generating potential social impact and financial return, focusing the attention of the Government on effective prevention practices, rather than on expensive programs, and saving public money by producing benefits for taxpayers.

The SIB funding works; however, in order to transform the curiosity of investors and traders in action, you need a joint effort on the part of the ecosystem that revolves around the instrument so that it creates a standardization of production practices, contracts, measurement models and implementation.

Every youth market requires standardization, particularly for the SIB in the years to come, it is necessary:

1. Develop an information campaign proper is important to overcome the fragmentation of information on the instrument so that the potential and risks of the SIB can be understood. The fundamental concept that must be disclosed is that, for now, the SIB is not a bond but rather a new and complex.

2. Testing the possibility of using the instrument in different areas: the process of adaptation of the SIB to cope with a new social problem may take quite long time. In the coming years it will take several pilot projects in different areas so that you identify the areas of intervention in which the SIB has recorded the highest probability of success, service providers have proven to be the most competent and effective, the government has had difficulties in registering public savings outcomes from social products, and experts have developed reliable metrics. It 'important to note that there is a possibility that these so-called core areas of intervention may be different from city to city, from region to region and from state to state.

3. Creating and disseminating models of cost-benefit analysis for each core area of intervention: the costs and benefits of SIB are different depending on the circumstances in which the work SIB (geographic, constituents, operational, and c.). To understand whether there is potential for implementation, it is necessary to analyse the financial costs, social costs and benefits that the SIB can produce in specific cases. Develop a model for analysing the costs and benefits of SIB relative to a specific area of intervention, and make it public, it means helping to accelerate the adoption of the same format in other cities, regions or countries.

Only through the achievement of a catchment area larger than that of the only philanthropic investors, SIB will in effect achieve the level of standardization required to be recognized as an effective source of funding for the scale-up of projects of public interest.

It is important to note, however, that the SIB is not only intended to replace the traditional philanthropy, but it is not an instrument capable of producing very high yields. And is implicit in the nature of the SIB have to remain an attractive tool exclusively for investors interested in the double-bottom line: social impact and financial return.

The model shown does not take into account statistical studies concerning the correlation between program outcomes and social product. Therefore does not provide the necessary size of a potential control group, nor the confidence interval within which it would be permissible to establish that the social impact was caused by the SIB. In addition, it is likely that the savings produced by the SIB on the public budget are different from those assumed in the analysis: the high level of fixed costs that the state supports to ensure some institutional services requires adjustments to capacity. For example, in the case of the homeless, there are high fixed costs for the state in the provision of health services (hospital staff, utilities, building maintenance, etc.). These fixed costs decrease exclusively in the case in which the reduction of the subjects using them is quite relevant too, for example, to shut down an entire wing of a hospital. In general, marginal reductions should impact on fixed costs in a manner not directly proportional.

At last, the natural evolution of the paper involves the spatial and temporal enlargement of the empirical investigation, so that we can perform a comparative study of the results and implement more extensive methodological deductive study techniques compared to the case study.

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