Scaling and Sustaining Pay for Success
Recommendations for Creating a More Sustainable and Scalable Financing Model

By Benjamin Nichols and Caroline Wagner

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About Enterprise Community Partners

Enterprise is a proven and powerful nonprofit that improves communities and people’s lives by making well-designed homes affordable. We bring together the nationwide know-how, partners, policy leadership and investments to multiply the impact of local affordable housing development. Over 35 years, Enterprise has created nearly 470,000 homes, invested $28.9 billion and touched millions of lives. Join us at www.EnterpriseCommunity.org.

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The Pay for Success (PFS), or Social Impact Bond (SIB), model is a financing mechanism designed to bring new investment and cross-sector collaboration to solving endemic social challenges. Projects are focused on improving an outcome or outcomes over a defined period. If projects are successful in achieving these outcomes, an “end payer” (typically a government partner) serves as the repayment source for the up-front private investment. The model has been used for projects in a variety of issue areas and geographies.

Since the first project using the PFS model launched in the United Kingdom in 2010, a great deal of research and analysis has followed the application of PFS in the real world. There are many differing opinions regarding the value of PFS, including the challenges in closing projects, the benefits of launched projects, the potential to scale successful projects, etc. This dialogue has served as a helpful feedback loop as the PFS field develops.

Enterprise has launched two Pay for Success projects and brought more than 35 years of experience as an investment syndicator, lender, funder and advisor for affordable housing and community development policy and programs. From this vantage, we have observed a gap in the PFS dialogue and identified a critical question that has been left relatively unexplored: How can the PFS model become more attractive to potential investors toward increasing the number of projects launched and people served?

As of June 2017, just 16 PFS projects have closed in the United States, and it remains inordinately difficult to take a PFS initiative from concept to launch. Because of this, the model is currently not a tool that can be replicated to achieve significant scale. If it were easier to get projects over the finish line, the PFS model could have an impact comparable to mature public-private partnership models, such as the Low-Income Housing Tax Credit (Housing Credit) for affordable housing. In previous reports and
in the public discourse surrounding PFS, stakeholders have identified a few common barriers to launching a PFS project. Explored in greater detail in this report, these common barriers include the high cost of predevelopment; difficulty generating cashable savings from oversubscribed social services; the “wrong pocket” problem, whereby the entity responsible for carrying out the service does not receive the ultimate benefit, and communication challenges among partners from different sectors.

In addition to barriers that interfere with launching projects, Enterprise believes the model has other less widely discussed substantive flaws preventing its scalability and sustainability. This report explores why the model currently utilized in the United States is an inherently – and perhaps prohibitively – risky model from the perspective of a prospective investor. To date, philanthropy has typically shouldered this risk by providing guarantees and grants or coming in as junior lenders in the capital stack. For private investors who are eager to participate in a PFS investment or have a driving interest in a project, PFS has been a suitable model. Moving away from a reliance on philanthropy, however, is critical to securing its long-term sustainability.

Establishing more standardized roles, tools and processes during a project’s predevelopment phase (sometimes called “feasibility” or “transaction structuring”) will also be critical to the model’s sustainability. To this end, Enterprise draws a comparison to the standardization that has occurred in the affordable housing sector’s use of the Housing Credit. There are lessons to be learned from the Housing Credit’s evolution, and the PFS field would benefit from following its example and moving toward standardization in areas such as underwriting, reporting and valuation of a deal’s soft costs.

Enterprise recommends PFS transactions include an appropriately matched risk-reward calculation for service providers. For example, providers should not be required to take on fixed costs without assurances that the project will be continued beyond the PFS term or without an appropriate financial return. Moreover, projects should further explore mechanisms that would give providers a financial bonus for outstanding performance.

Finally, Enterprise draws a distinction between project and asset management. Project management is used in many PFS projects to maintain coordination and communication among a project’s various players. Investors in these projects still hold the responsibility of asset management. That is, no one else is tasked with protecting their investment. PFS projects often require a high-level of engagement for investors even after launch and throughout the project’s duration. Introducing an asset management function could be attractive to investors with a lower risk appetite or who do not have the interest or resources to devote to project oversight.

When it comes to the future of PFS, many questions remain. Is PFS here to stay, and will the model grow and spread? Enterprise believes in the potential of PFS to accelerate impact and improve people’s lives. But to significantly scale, the model must be adapted.
Pay for Success (PFS) projects, sometimes called Social Impact Bonds (SIB), are viewed by many as a transformative new tool for funding social services. Since the first PFS project launched in the United Kingdom in 2010, stakeholders in the public, private and nonprofit sectors have spent considerable resources assessing the feasibility of various project models. Despite this attention, only 16 PFS projects have successfully closed and launched in the United States in more than six years of robust activity.

This paper reviews lessons learned from Enterprise’s involvement in PFS as well as other past public-private partnership models, and suggests improvements to the PFS model that would allow for more scalability and therefore greater impact. In addition to drawing from our own experience and expertise in credit and capital markets, real estate syndication, policy advocacy and impact investing, we consulted with three current PFS investors, two potential PFS investors, and a leading PFS transaction coordinator. In these conversations and in our literature review, Enterprise solicited opinions on questions such as, what changes would make the transaction structuring process more efficient? What changes would make PFS projects more replicable? What does the future of PFS look like?

Interest in these public-private partnerships remains high despite the well-documented challenges associated with launching PFS projects. These challenges include, most notably, inefficiencies in the predevelopment process and complex deal structure that have become typical of PFS projects. Changes to the model are needed to get more projects closed and programs funded. To this end, we support a role for the federal government that would lower deal costs, align risk with investor return, expedite the number of deals coming to fruition and help sustain and scale the PFS model long-term.

Participating in PFS projects has been an important experience for Enterprise. It has emboldened us to work smarter toward our vision that one day, every person will live in an affordable home in a vibrant community, filled with promise and the opportunity for a good life.

1. These challenges have been well-documented since the launch of the first PFS project in the United States. Notably, the “Stanford Social Innovation Review” has entertained a lively debate on the merits and challenges of PFS in a series of think pieces on the topic. Two articles that elicited responses from prominent PFS stakeholders are “The Payoff of Pay-for-Success” and “Pay for Success: What It Will Take to Work.” Both outline the model’s major shortcomings when it comes to scaling and replicability. In March 2016, George Overholser, the CEO and co-founder of Third Sector Capital Partners, wrote a blog introducing a new financing tool called the Social Impact Guarantee, noting that the new model’s challenges “seem to be considerably less onerous than the challenges we have dealt with while implementing SIBs.” See the appendix for more information on the think pieces that have contributed to a national dialogue on PFS and to the collective understanding that PFS is a challenging model to implement.
Since its founding in 1982 by the urban planning visionary and entrepreneur Jim Rouse, Enterprise has participated in the growth of one of the country’s premiere, highly successful public-private partnership models: the Low-Income Housing Tax Credit (Housing Credit). As Enterprise President and CEO Terri Ludwig has shown, there are parallels between the Housing Credit and the PFS model. In both cases, private capital is directed to a social intervention that is otherwise difficult to fund through market or government investment alone. As in PFS projects, in Housing Credit projects, the government does not pay out and investors do not yield any financial benefit until targeted program outcomes are met (e.g., a low-income family occupies an affordable home). Further, the government has the right to “claw back” Housing Credits from investors if the project is found out of compliance for the agreed-upon 15-year period.

Over three decades, the community development and affordable housing sectors have figured out how to deliver this particular social good – affordable homes – through a model that is reliable and replicable. The Housing Credit provides an illustrative example of how public-private partnerships can operate at scale while providing both a financial and social return on investment.

Like PFS, the Housing Credit experienced its own growing pains in its first decade. Early investors accepted greater risk commensurate with a related financial return. Eventually the model matured, and all transaction partners became more efficient in closing transactions, which became far less risky. Housing Credit investments now account for an estimated 90 percent of all affordable housing financed in the United States. Enterprise alone has invested more than $11 billion across 2,100 Housing Credit developments, helping to create close to 137,000 affordable homes. While far from a perfect comparison, the Housing Credit is a successful public-private partnership that can help illuminate what is currently missing from the PFS model and how to improve it.

In addition to our experience as a Housing Credit syndicator, Enterprise serves as financial intermediary for two closed PFS projects in Denver and Cuyahoga County, Ohio. Our intimate involvement in both assembling and operating these early projects has identified a handful of ways in which the model could be brought to greater scale for the benefit of people and communities.

As of June 2017, 16 PFS projects have launched in the United States. While they have made it over the finish line to close, many more projects are in development. There is clearly a robust demand for PFS projects in communities across the United States as evidenced by these indicators:

- Since 2014, the Corporation for National and Community Service (CNCS) has awarded $18.1 million to eight organizations facilitating PFS projects. These grantees have passed through $12.3 million to 65 subgrantee organizations in 25 states. CNCS also reports that nearly 200 organizations applied for subgrantee awards through the Social Innovation Fund’s Pay for Success competitions in 2014 and 2015.

- Third Sector Capital Partners, Harvard’s Government Performance Lab, and Social Finance are the most prolific nonprofit consulting organizations that specialize in helping develop Pay for Success projects. Combined, these organizations are currently working on more than 40 PFS projects in either feasibility or transaction construction.

- In a new, jointly administered program, the U.S. Departments of Housing and Urban Development and Justice awarded nearly $8.7 million to seven organizations developing PFS projects related to chronic homelessness and jail/prison recidivism.


• The U.S. Department of Education awarded nearly $2.3 million to support the development of PFS projects in career and technical education and early childhood education. In coordination with the U.S. Department of Health and Human Services, the Education Department is also preparing to award an additional $2.8 million to fund feasibility analyses for PFS programs in early childhood education.8

• Nearly every state government is exploring or has explored PFS through legislative action, agency-led feasibility studies, Requests for Information, Requests for Proposals, or state-level competitions.9

Although we’ve observed considerable PFS activity around the country, the reality remains that these projects are difficult to launch due to the customized nature of the transactions and large number of stakeholders with competing concerns. Nevertheless, the process of putting a PFS project together carries intrinsic value that often cannot be measured or monetized. Regardless of whether a transaction closes, the added value may include strengthened business relationships, increased integrated data gathering and analysis for a community or group of people, or a more effective service delivery model. Yet these value-added gains only reach so far; partners may devote tremendous time, energy and resources to a project that does not come to fruition.

Communities across the country have great need for effective, well-funded social services targeted to low-income and particularly vulnerable people. Growing interest in PFS is evidence that the government, nonprofit and private sectors are eager to work together and willing to operate outside the box. It took many years for affordable housing stakeholders to build a shared understanding as well as the policies and practices to ensure Housing Credit projects are efficient and effective.

Acknowledging that significant differences exist between the Housing Credit and PFS, it should be a goal to see PFS become a similarly reliable, cost-effective and replicable model for investing in the nation’s underserved communities and residents.


While each of the 16 launched PFS projects in the United States has unique aspects to its structure, funding generally flows according to the model above.

In the PFS model, private investors provide up-front capital – not by purchasing a bond, but by entering into a loan agreement with a financial intermediary that manages the flow of capital to its intended recipient: a service provider or providers. The capital is used to fund a program intervention as well as other costs associated with the program, including, for example, project management and in some cases, the costs of an independent evaluation. Since the program intervention does not generate cash by itself to repay the loan, another entity enters the transaction to serve as the repayment source for investors. In the typical PFS model, government is expected to accrue savings because of the successful programmatic intervention, and a share of the savings is intended to serve as the source of a return on this investment.\(^\text{10}\)

Understanding how funding flows in a PFS project helps explain some of the model’s common challenges. Many of the challenges with the PFS model arise because PFS projects do not have the benefit of a durable asset to serve as repayment (or collateral). The financial mechanism of a PFS project, then, is technically unsecured working capital or a bridge loan. Greater risk associated with unsecured lending leads investors to expect shorter terms (five years vs. 30 years). Because of this, the PFS model is limited to challenges that can be realistically solved in about five years. Alternatively, project partners may take on the extremely difficult task of finding appropriate short-term proxy measures for long-term outcomes, which adds another layer of risk.\(^\text{11}\)

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\(^\text{10}\) While most projects have utilized public end-payers, this is not always the case. Some PFS projects in development are exploring the use of private entities (e.g., health insurers) as the end-payer.

\(^\text{11}\) For example, the Denver Housing to Health Social Impact Bond uses the proxy measure of “housing stability” as a project outcome, because research indicates that increased housing stability leads to other positive outcomes with cost-saving implications for the city and county of Denver.
Many practitioners, researchers and scholars have written about the promise of the PFS model and its potential to unlock some of society’s most endemic challenges. As more organizations work to develop PFS projects in their own communities, increasing attention focuses on lessons learned and making improvements to the model. Most stakeholders familiar with PFS projects agree on a few major challenges:

1. The costs of “predevelopment,” including legal expertise, are significant. Without a way for the project to adequately cover predevelopment costs, partners typically seek grant dollars. These costs present an immediate and sometimes prohibitive barrier for organizations interested in PFS.
   
   **Example:** In Enterprise’s experience, predevelopment structuring costs can run from $200,000 to $400,000 for a given project. Most or all partners in a PFS project absorb significant costs during the development of PFS projects, which can take from two to even four years to solidify.

2. Public, private and nonprofit sectors are forced to collaborate – which is a good thing. But because they speak different languages and have varied familiarity with the population or program at hand, roles and accountability can become blurry, and negotiations can be drawn out, frustrating, and in some cases, fruitless.
   
   **Example:** During the development of the Cuyahoga County Partnering for Family Success project, investors had to conduct due diligence on a wholly new financing model while at the same time learn the nuances of the county’s foster care system.

3. Many services are oversubscribed so that when program participants have successful outcomes, no cash savings are recognized by government as they continue to serve the same number of clients.
   
   **Example:** Imagine a project that aims to reduce the number of days that people spend in detox treatment. If a community is among one of the many nationwide experiencing the effects of the opioid epidemic, the project probably will not generate cashable savings because the demand for detox services is already greater than the supply. If a successful intervention allows someone to move beyond detox treatment, it simply frees up the capacity of the provider to serve one of the many other individuals waiting to access services.
4. Government entities may struggle to find the relation between program outcomes and savings due to a program’s low capacity, lack of data or other systems issues. When connections are found, the savings recognized may not directly tie to the government body participating in the PFS program. This is commonly referred to as the “wrong pocket” problem.

**Example:** A PFS project focused on early childhood education may yield benefits well beyond the intended scope of the initiative. For example, a child receiving pre-K as part of a PFS intervention may have better employment prospects later in life and ultimately reduce government expenditures in areas such as TANF, SNAP, Medicaid, etc. These “savings” may occur at the federal, state or local levels, and they may not be realized until decades after the project officially concludes. Ideally, programs should be able to factor these savings into their economic models, but they currently cannot.

Challenges are familiar to practitioners who have worked on a PFS project, many of whom will readily share their “war stories” of how these issues can contribute to a slow-down or stalemate during project development. Such challenges have been thoroughly covered in other PFS papers and reports, and many stakeholders across the field are working to remedy them.\(^\text{12}\) While these common challenges have made it harder for transactions to close, many of the issues highlighted above can and will be mitigated as governments, funders and providers become more practiced in closing PFS transactions.

Some barriers inherent to PFS have received less attention to date, but have a greater long-term impact on the scalability and replicability of the model. This paper focuses largely on identifying these less-discussed challenges and providing recommended solutions. Putting remedies into practice will be difficult, but the potential payoff is worth it: As the model is made more efficient and taken to scale, millions of lives will be improved substantially through greater marketplace investment in vital programs and services.

\(^{12}\) These challenges were identified using two filters: 1) Enterprise’s experience in launching two PFS projects between 2014 and 2016, and 2) a review of reputable PFS-related literature. The addendum of this report lists articles, reports and other resources that informed this paper.
What’s Required for Long-Term PFS Sustainability?

Standardized Roles, Tools and Processes

Enterprise is well-versed in public–private partnerships given our work with the Housing Credit. Organizations working in affordable housing using the program have come to rely on clearly defined roles, practices and policies to create efficiencies in these transactions. The collaboration and partnership in a Housing Credit deal are comparable to that of a PFS project in a few key aspects:

• A Housing Credit transaction typically involves a housing developer (often a nonprofit organization), a financial intermediary and commercial investors. It requires involvement from one or more government agencies.

• The partnership involves intensive negotiation and collaboration up front to “close the deal,” and continued communication through the project’s duration.

• A high level of specialized financial and legal expertise is needed.

• The Housing Credit model is designed to deliver a social good via private investment. Investors do not realize any financial upsides (Housing Credits) until residents have moved into their homes. Just as with PFS, if the social good is not delivered successfully, investors lose their investment.

While important parallels exist between the two models, unsecured lending that helps deliver social services through PFS, and equity investments used to build affordable housing with support from the Housing Credit, have major differences in risk, rate of return and other elements. Moreover, the standardization that has occurred in terms of Housing Credit partner roles and processes has allowed projects to scale in a way that is currently out of reach for PFS, because each PFS project is executed so differently.13

PFS projects eventually will need to develop efficiencies in both roles and processes that would decrease transaction costs and lower the barriers to entry. We have identified several areas ripe for standardization today that will better support the model over the long term.

Shared, Independent Underwriter

The process by which partners conduct due diligence and financial underwriting is a great source of inefficiency in the development of a PFS project. Multiple investors with varying degrees of familiarity with the program area at hand – and varying degrees of experience in multiparty, long-term contractual financial agreements – conduct their own internal underwriting to shepherd the project through their respective credit committees. It is not uncommon to have six or more investors participating in a PFS project, and it can be onerous for all involved to determine exactly what information they need, when and from whom to feel prepared to close the transaction.

We believe the PFS model would benefit from a standardized independent underwriter that is shared among investors in a similar way that a Housing Credit syndicator organizes a multi-investor fund and underwrites investments on behalf of all investors. In the PFS field today, a transaction coordinator may provide some level of financial underwriting but this function is handled differently for each project. Typically, underwriting is spread across multiple parties.

In addition to customary financial underwriting, PFS projects also require a high level of programmatic underwriting. To close a transaction, investors (and all partners) must understand the underlying issue being addressed by the project, precisely how the programmatic intervention works, the vulnerabilities of the intervention and the likelihood of failure. Understanding the specifics of the intervention requires a much different knowledge base and

13. To see the breadth of variations in PFS project execution, the Nonprofit Finance Fund’s recent report, “Pay for Success: The First Generation,” includes helpful charts that break down each launched project (as of April 2016) by its major features. [http://www.payforsuccess.org/sites/default/files/resource-files/Pay%20for%20Success_The%20First%20Generation_0_0.pdf](http://www.payforsuccess.org/sites/default/files/resource-files/Pay%20for%20Success_The%20First%20Generation_0_0.pdf)
skill set than underwriting a real estate or small business deal. Today, financial and programmatic underwriting is more likely to be completed by different entities. In our experience, much of the underwriting falls to individual investors who complete their own financial and programmatic due diligence in-house. As the market matures, however, these can roles can merge. Either transaction coordinators currently active in the sector will build substantial issue area expertise, or organizations with deep expertise in an issue area will develop financial underwriting and transaction structuring skills. In either case, standardizing a centralized, independent underwriting function that is compensated will be key.

Moving toward a consolidated transaction consultant/financial intermediary role also can be complex. Perhaps the most substantial difference between the current role of a PFS intermediary/fiscal agent and a Housing Credit syndicator rests on fiduciary duties and related liabilities. The nature of the Housing Credit’s limited partnership/equity model means syndicators have a fiduciary duty to their investors, and carry all the liabilities that come with those fiduciary duties. A PFS intermediary, on the other hand, manages an independent special purpose vehicle to facilitate the pass-through of loan funds. As a PFS intermediary, Enterprise does not hold the same fiduciary duty to investors and has limited liability as compared to a Housing Credit transaction in which Enterprise is the syndicator. This issue deserves far more time and detail than this paper can explore. But as the field pursues greater consolidation of transaction functions, sorting through these questions will be critical.

Moving forward, the field may develop even more efficient risk assessment measures. In his Huffington Post piece in May 2016, Jason Saul, the CEO of Mission Measurement, argues that the PFS field should develop “standardized, independent, predictive assessments of risks and returns” akin to the rating system in the municipal bond market. Until this level of standardization and potential consolidation occurs, however, PFS partners should understand the importance of both financial and programmatic underwriting. Second, investors should seek efficiencies through an independent underwriter that all investors trust, and that has the responsibility at the outset to deliver and share a thorough investment analysis with all investors.

**Due Diligence Reports**

In a Housing Credit transaction or other real estate deal, investors expect market studies, appraisals, and environmental and other reports to outline the important physical and economic features of the project and the community in which the asset is located. While these reports may vary depending on the underwriter, they generally cover a similar breadth of topics. Investors come to expect the same types of information in an underwriter’s investment analysis. Standardizing the use of these tools for PFS investments would help reduce confusion and inefficiencies among all partners.

There are two aspects to standardizing due diligence reporting. The first is standardizing the tools themselves. In other words, what information should each contain? What financial calculations are necessary? Where should the information come from? How should it be presented? Helping the PFS sector standardize due diligence reports could be a role for an entity with deep experience in PFS transactions, such as the Harvard Kennedy School’s Government Performance Lab.

The second aspect of standardization will require more widely available data on populations and interventions applicable to PFS projects. Social Finance similarly highlighted this issue in its report, “Social Impact Bonds: The Early Years.” In 2013, the United Kingdom introduced a unit cost base that acts as a free online clearinghouse for cost estimate data on different social issues and interventions. In the Housing Credit world, the accounting firm CohnReznick compiles

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and publishes national operating expense data on affordable housing developments for the benefit of affordable housing developers, investors, syndicators and property managers. Whether government, universities or another entity hosts this repository of information, building this shared resource for PFS would facilitate standardized reporting, and advance the evolution of the PFS sector in the United States.16

Understanding and Valuing the Intangible Soft Costs in a PFS Transaction

In many ways, launching a PFS project is like embarking on a scavenger hunt. At the outset, you cannot anticipate the full range of questions and activities that emerge. Some of these activities fall outside of the typical tasks associated with closing a financial transaction. These “deal intangibles” are the tasks that must be completed to navigate the idiosyncrasies of a particular political landscape and successfully execute a PFS transaction. Activities in this category may include but are not limited to:

• Pursuing regulatory and legislative changes
• Educating policymakers
• Securing additional non-cash resources
• Relationship management among partners
• Navigating political transitions
• Community engagement and/or addressing potential NIMBY issues
• Managing local (or national) press

In a PFS project, these functions do not inherently rest with a particular partner. For the transactions in Denver and Cuyahoga County, for example, Enterprise as the financial intermediary did not initially expect to be involved in raising awareness among elected officials or securing housing units. But because Enterprise has a longstanding presence in both communities, we could help navigate the local terrain. Experienced practitioners recognize that these duties will come up, but it often falls outside the scope of work that transaction consultants or financial intermediaries typically expect in a PFS project.

To the extent partners can acknowledge and anticipate these types of specific activities, the more efficient the transaction. Partners should discuss openly which partner would be able to add value among the “deal intangibles” and be explicit about their expectations on roles and responsibilities.

In a Housing Credit collaboration, transaction-related activities usually fall to the affordable housing developer,

<table>
<thead>
<tr>
<th>Transaction Consultant Responsibilities</th>
<th>Intangible “Soft Costs”</th>
<th>Financial Intermediary Responsibilities</th>
</tr>
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<tbody>
<tr>
<td>• Recruits investors</td>
<td>• Navigates political processes, educating policymakers</td>
<td></td>
</tr>
<tr>
<td>• Creates economic model</td>
<td>• Pursue regulatory and legislative changes</td>
<td></td>
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<tr>
<td>• Negotiates terms with investors on behalf of government partner</td>
<td>• Address NIMBY</td>
<td>• Creates Special Purpose Vehicle</td>
</tr>
<tr>
<td>• Negotiates terms with investors on their own behalf for project fees, etc.</td>
<td>• Liaison with service provider(s)</td>
<td>• Manages disbursements</td>
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<tr>
<td>• Lead closing process</td>
<td>• Project management/advise ment</td>
<td>• Manages financial reporting</td>
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<tr>
<td></td>
<td>• Manage partner relationships</td>
<td>• Negotiates terms with investors on their own behalf for project fees and other costs</td>
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<tr>
<td></td>
<td>• Secure key programmatic features/additional resources (e.g., housing vouchers)</td>
<td></td>
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<tr>
<td></td>
<td>• Manage local (or national) press</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Navigate political transitions</td>
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</tbody>
</table>

16. The introduction of the “Outcomes Rate Cards” competition in 2017 by Social Finance marks a step toward better understanding of existing data outcomes, interventions and potential cost savings.
who is compensated by a developer’s fee that is paid out of the project. It would be worthwhile for the field to consider whether it makes sense for the PFS model to evolve and consolidate these intangible tasks under one partner’s purview, such as the service provider. Obviously, service providers would need both strong internal capacity and assurance of appropriate compensation. In the meantime, PFS partners should expect a certain amount of “other duties as assigned.” Partners should cost these activities, and funders should expect regular soft costs in project budgets.

Addressing Risks to Service Providers

Service providers take on both financial and reputational risk when they agree to a PFS partnership. Providers who begin scoping a project could invest significant resources into projects that never come to fruition. As mentioned earlier, providers (along with other PFS partners) do not recover the costs of predevelopment unless they secure grant funding. Service providers – many of whom already operate at extremely tight cash margins – should be incentivized and rewarded appropriately for the risk they incur. The up-front capital providers receive to implement the intervention should not be mistaken as a financial incentive; it is the funding needed to deliver services. While this funding gives providers important flexibility and frees them of the burdens of more typical fee-for-service reimbursement, it does not mitigate the risk providers take on to operate a PFS project. Additionally, the fixed costs providers take on (e.g., updating data systems) for the project to operate successfully should be appropriately compensated.

One of the PFS model’s potential benefits is its ability to strengthen the nonprofit sector by instilling greater rigor around performance management and data collection. Yet while providers are asked to stretch and grow for a PFS project, the model does not offer the appropriate financial reward for those providers who successfully make strides. PFS projects should offer nonprofits the opportunity to earn a sizable financial bonus for outstanding performance to recognize that nonprofits are businesses that require strong financial health to operate successfully. Some PFS projects have included financial incentives for service providers; however, these projects are currently the exception rather than the rule.

PFS projects typically lead service providers to expand staff to carry out the intervention effectively. But what happens to that staff at the completion of the PFS project? This question is looming in the PFS field. For service providers, ambiguity over how a PFS partnership unfolds has significant implications for their budget and operations. PFS contracts currently do not put the government entity under any obligation to continue the intervention after the PFS

RECOMMENDATIONS: STANDARDIZED ROLES, TOOLS AND PROCESSES

Below are recommendations for partners to consider before engaging in a PFS project, as well as recommendations for standardizing roles, tools, and processes within the PFS field.

• Standardize role of shared, independent underwriter in PFS transactions that is paid out of the deal.

• Explore use of standardized due diligence reports that will be both familiar to investors and help streamline the process for presenting the important economic factors impacting a PFS project.

• Early on, identify the “deal intangibles” that need to be solved before the project can launch and talk frankly about who will be responsible for these activities.

• Discuss and put a value on soft costs, and work with investors to ensure they understand their value. Recover these expenses at the investment closing and ensure they are budgeted as part of the investment structure, if not compensated prior to closing.

• Collectively, the PFS field should support the development of an independent and publicly accessible clearinghouse for PFS-related data, particularly cost data related to PFS-service interventions.

• Over time, the field should explore the consolidation of the responsibilities of the transaction consultant and financial intermediary into a role more akin to a Housing Credit syndicator.
project term. To maintain consistent operations and be fair to their employees, providers should know well before the official end of the project whether the program will continue in some form or fashion. If the project’s future lingers in uncertainty, the provider has two options: 1) spend precious resources retaining staff and continuing program operations without assurances of future funding, or 2) downsize staff, wind down the program and risk having to start from square one if the government payer decides to fund the program directly. In either scenario, the provider is put in financial peril to the detriment of its staff, clients and the communities it serves.

In its July 2016 report, Social Finance illuminated the issue of concluding a PFS project. It questioned whether a PFS project would be able to convert to a direct-reimbursement model, characteristic in social service delivery today. The report notes that “there is a real challenge for a fee-for-service model to be able to deliver the flexible, performance-based, outcomes-focused elements of the Social Impact Bond model.”

Over the next several years, we will see how projects currently in motion handle the issue of project wind-down. Their experience promises to help inform a viable path. In the meantime, project partners should explore how to make it possible to assure service providers that successful programs will continue. Reducing the uncertainty around project conclusions is vital to ensuring the long-term financial health of providers.

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 Asset Management vs. Project Management

In a PFS project, the investor works to mitigate risk by negotiating exits and other clauses in the contract. The contract is the governing document for PFS projects. Contract negotiations can be an especially high-pressure process during the launch of a PFS project. While partners do their best to anticipate all potential project pitfalls and write contingency plans into a contract, it is impossible to create a contract that will provide guidance for every scenario.

A typical PFS project will utilize a project manager who works on behalf of all partners to facilitate project operations. The project manager will work to proactively identify potential issues and problem solve accordingly for the collective benefit of all partners. While valuable, this role is different from that of a Housing Credit transaction’s asset manager, who explicitly works on behalf of investors to protect their investment.

After the contract is signed, it is incumbent on the investor to represent its continued interests and protect its investment. The investor does not have an asset manager working explicitly on its sole behalf to utilize or enforce these contractual provisions throughout the project’s duration. To be sure, project managers will identify and alert investors – and all partners – to potential contract breaches or areas of ambiguity or concern. But ultimately the project manager is working on behalf of all partners, not solely investors.

In general, PFS projects require a high level of continued attention and engagement from investors. While some investors appreciate this ongoing engagement, it may be a deterrent for others. An ongoing asset manager who works directly on an investor’s behalf could make PFS projects attractive to a wider range of investors that do not have the capacity or interest in maintaining high-touch involvement in PFS projects.

**RECOMMENDATION: ASSET MANAGEMENT VS. PROJECT MANAGEMENT**

Investors less interested in high-touch engagement after project launch should explore use of an asset manager or similar function that works explicitly on their behalf to mitigate operational risk throughout the course of the project.
Mitigating Investor Risk

For all the reasons outlined previously, PFS projects are inherently risky. To date, the model has relied heavily on the philanthropic sector to mitigate risk as well as on investors that are willing to accept higher risk and lower returns. If the PFS model is to scale and sustain itself over the long term, however, other avenues for risk mitigation must be utilized and the risk/return tradeoff must be right-sized.

There are a number of reasons why PFS projects as currently structured are less desirable to private investors.

- Because PFS investments are unsecured loans, there is a limited pool of potential PFS investors interested in or able to participate in these projects. Many investors – including mission-driven investors such as community development financial institutions – have limits on the amount of unsecured lending in their portfolios. Investors and lenders look for a durable asset that can serve as a source of repayment. Service providers are typically unable to offer the kind of collateral or guaranties required to make investors comfortable.

- Beyond collateral, having some investors in a top-loss or second position to protect their investment could help mitigate risk for other investors. In most PFS projects to date, philanthropy has stepped in to serve this top-loss role.

- Governments participating in a PFS project will typically have a contractual obligation to appropriate future funding for potential PFS outcome payments. According to McKinsey & Company, “Without special legislative authority, the government’s obligation to pay SIB investors will not be commensurate with its obligation to pay traditional municipal bondholders.”

Some transactions (namely those launched in Massachusetts) do have the benefit of having the full faith and credit of the participating municipality pledged to the project. Lacking this security, however, is a tremendous barrier for investors, and even investors who can get comfortable enough to move forward have added uncertainty when administrations or legislatures take control or when priorities change.

- While a few projects in the United States have utilized a philanthropic guaranty, typical PFS projects do not provide guaranties to the PFS investor. The high-risk nature of the PFS structure models an equity system akin to a Housing Credit project, but does not provide guaranties or earned fees and uses a debt return/yield. The risk-reward calculation for investors and cost-benefit analysis for intermediaries are not aligned.

Like many debt products, PFS projects need some type of credit enhancement to make them viable. To date, philanthropy has provided credit enhancement in the form of subordinate debt and/or stand-alone guaranties. But philanthropy will not be able to shoulder this weight forever, and the PFS model will need to find ways to sustain and grow in transaction size or number over the long term.

An asset manager working directly on behalf of investors could increase the appeal of PFS projects to investors.
RECOMMENDATIONS: MITIGATING INVESTOR RISK

In June 2016, the U.S. House of Representatives passed bipartisan legislation that would expand federal support to state and local PFS initiatives. The Social Impact Partnerships to Pay for Results Act (H.R. 5170) would establish a new interagency council to identify, support and monitor eligible state and local PFS projects that could save federal dollars. It would also create a new 10-year, $100 million fund within the Treasury Department to support eligible projects by either paying for successful outcomes or funding feasibility studies and third-party evaluations. A similar bipartisan bill was introduced in the U.S. Senate in April 2015 but never received a full vote. Though the bill was not signed into law, Enterprise supported H.R. 5170 as a first step toward solving the “wrong pocket” problem facing many state and local PFS projects.

Similarly, reintroduction of the bill in the 115th Congress in the Senate (S. 963) and the House (H.R. 576) is promising. However, as the bill moves forward in the House and companion legislation is introduced in the Senate, Enterprise urges lawmakers to consider the full array of potential roles the federal government can play in support of PFS projects. For example, H.R. 576 and S. 693 both explicitly prohibit the proposed fund from providing “any insurance, guarantee, or other credit enhancement” to eligible projects.

As mentioned above, credit enhancement can make a PFS project financially viable. To help the PFS model reach significant scale, projects will need access to additional forms of credit enhancement beyond what philanthropy can provide. The federal government is well positioned to provide credit enhancement under certain circumstances, and has done so in programs such as the Small Business Administration’s 7(a) loan program or the State Small Business Credit Initiative administered by the Treasury Department.

PFS STAGE: Feasibility

Potential Federal Government Roles

- Support PFS project development by providing grant funding to support the staff time and research required to design projects.
- Reduce legislative and statutory barriers that may prohibit PFS projects.

PFS STAGE: Transaction Structuring and Operations

Potential Federal Government Roles

- Government at all levels – local, state and federal – and in concert can serve as end-payers for PFS transactions, alleviating the “wrong pocket” problem.
- Provide top-loss in the capital stack of PFS transactions, limiting risk and making projects more aligned with investors’ underwriting guidelines.
- Provide limited guarantees for PFS transactions, transforming PFS products from unsecured to secured loans and expanding and diversifying the pool of potential investors.

PFS STAGE: Evaluation

Potential Federal Government Roles

- Provide funding to local, state and federal agencies to update IT infrastructure and develop integrated government data systems that can better facilitate multi-year, multi-agency program evaluations.
- Provide grant funding to support the development and implementation of specific PFS program evaluations.
- Develop within government, or support the external development of, data clearinghouses to collect and make available data on the programmatic impact and cost-saving potential of specific PFS interventions.

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20. The Small Business Administration’s 7(a) loan program guarantees up to 75 percent of loan value for smaller loans and 85 percent for larger loans. Eligible small businesses use 7(a) loans for short- or long-term working capital, capital equipment purchases, real estate acquisitions and refinancing of other business debt, among other eligible uses. More information on the SBA 7(a) loan program is available here: [www.sba.gov/loans-grants/see-what-sba-offers/sba-loan-programs/general-small-business-loans-7a](http://www.sba.gov/loans-grants/see-what-sba-offers/sba-loan-programs/general-small-business-loans-7a). The State Small Business Credit Initiative program provides funding to states, territories and other eligible municipalities for credit-enhancing programs such as collateral support programs, loan guarantee programs and venture capital programs.
Moving Toward Broader Systems Change

Enterprise is part of a larger chorus of voices helping to educate and advocate for policies that will support the development and growth of innovative, public/private partnership models such as Pay for Success. These models have the potential to unlock new pools of resources, expand our understanding of effective models of social service delivery and help connect more families to opportunity.

PFS projects help to illuminate where our social service systems are failing to maximize results. These projects hone in on a given community and force a new level of collaboration and communication among public, private and nonprofit systems. The expectation is that giving government agencies and service providers permission to think and act outside of their modus operandi leads to systems change. Indeed, partners in Cuyahoga County and Denver have seen PFS projects in their respective communities lead to systems change. In Denver, for example, the project led to a new level of partnership between police and two local service providers. Officers on patrol help to identify and recruit individuals currently living on the street who are eligible for supportive housing.

In Cuyahoga County, the county’s public housing authority has opened new channels of communication and formalized partnerships with the county child welfare agency and the PFS nonprofit provider to identify and help secure homes for homeless and housing-insecure families who are also involved in the foster care system.

PFS projects generate real-time data and many anecdotal stories to support what we intuitively know to be true: the handful of financial incentives and federal funding streams that social service and community development organizations rely on are not designed for prevention-focused interventions and are almost entirely disconnected from one another.

Pay for Success helps us imagine a world in which social service systems are integrated and produce better outcomes for the people they serve. It may work on the margins, but the PFS model itself will not produce the tremendous scale needed in communities nationwide. To truly reach a scale that creates opportunity for tens of millions of people, we must broaden our focus to consider all the funding streams and major institutions touching low-income communities. Imagine if a community could easily align private Community Reinvestment Act investments, public Community

Cuyahoga’s Partnering for Family Success program

The nation’s first county-level PFS project launched in Cuyahoga County, Ohio, in January 2014. With the support of three local philanthropic investors and two national community financial development institutions, the five-year, $5 million project is serving vulnerable families who are homeless or housing insecure, and involved in the county child welfare system. A local service provider, Frontline Service, helps families gain stability at home, while providing evidence-based case management and trauma services. The program will serve 135 families over five years and includes a random control trial evaluating service delivery interventions. Repayment by Cuyahoga County will be contingent on reducing the number of days children from participating families spend in foster care.
Development Block Grant dollars and local water/sewer taxes to fund a home lead-abatement program? What if Medicaid could be braided with a local hospital’s community benefits to pay for an affordable housing development? Projects of this scale could unlock tremendous human potential and produce government savings well beyond the magnitude of PFS projects.

Ultimately, we must position communities to strategically align funding streams across various levels of government and institutional stakeholders. Keeping this larger goal in mind is important if we are to move beyond incremental innovations like the PFS model. PFS projects have the potential to improve thousands of lives, save millions of dollars and energize human potential. True systems change, such as the examples above, however, would prove even more far-reaching.

There needs to be continued focus at the federal level to untangle the interrelated and costly challenges related to the country’s neediest populations, including homelessness, increased rent burdens, high incarceration rates and rising health care costs. The extent to which we can continue – through PFS or otherwise – to break down funding silos across all levels of government and sectors and better align funding streams, the closer we get to solving our society’s most endemic problems.

To be sure, our job does not end with improving the PFS model. The issues these projects attempt to solve are bigger than one public-private partnership. One, 100, or 500 PFS projects will not be the means to ending generational poverty and ensuring every American a life connected to opportunity.
Conclusion

So much has been written about the PFS model in recent years that it can be easy to forget how nascent the field is, and how few projects are currently in operation. Enterprise holds a unique position as both a “PFS insider” and an outside observer. As a contractual partner in two PFS transactions, we know firsthand the challenges and rewards these projects hold. We have also contributed to efforts to scale PFS, including advocating at the federal level for legislation expanding the PFS model. At the same time, Enterprise works well beyond the boundaries of its two operational PFS projects. With Housing Credit investments in all 50 states and offices in 10 markets across the country, Enterprise views PFS through the lens of its broader work in affordable housing and community development.

Given our experience in the field to date and our history of engagement with the Housing Credit, Enterprise sees the tremendous potential in PFS projects. We also see serious challenges. Many of these challenges have been raised and discussed at length by others in the PFS field – the “wrong pocket” problem, data availability and expensive predevelopment, to name a few.

Nonetheless, we believe there is a “sweet spot” where innovation meets long-term viability. To ensure its sustainability, the PFS model must move away from its current reliance on philanthropic investment, and projects must find more sustainable sources of credit enhancement. There are precedents for the federal government to play this role, and the PFS field would benefit from exploring such models further.

We hope this paper contributes to a frank dialogue on the future of PFS projects and policy, sparks new thinking and ultimately helps the PFS field mature. We see the potential of PFS to drive the most powerful force in creating opportunity: human capital. The PFS model layers human capital strategies with place-based assets, but this nascent tool requires realignment to reach its full potential.
Any partner organizations, researchers and scholars have contributed to the body of thoughtful and forward-thinking literature describing the PFS model, documenting results to date and presenting recommendations. While not a comprehensive list, the following resources informed this report and offer a useful knowledge base for understanding the origins of PFS and its evolution to date.

**Online Resources**

The Nonprofit Finance Fund Pay for Success Learning Fund: This is the most comprehensive clearinghouse for PFS activity, including funding announcements, publications, fact sheets and toolkits. [www.payforsuccess.org](http://www.payforsuccess.org)

Urban Institute: The Pay for Success Initiative at the Urban Institute compiles opinion, analysis, toolkits and a support center. [http://pfs.urban.org](http://pfs.urban.org)

**Articles**


Saul, Jason. “Pray for Success: How to Take the Guesswork Out of Social Finance.” Huffington Post (May 12, 2016). The CEO of Mission Measurement recommends three changes to the PFS approach that would ideally result in more accurate assessments of project risk. [www.huffingtonpost.com/jason-saul/pray-for-success-how-to-t_b_9914808.html](http://www.huffingtonpost.com/jason-saul/pray-for-success-how-to-t_b_9914808.html)


**Papers and Reports**


**Additional Federal Information**

In 2014, President Obama proposed the creation of a $300 million PFS incentive fund in his annual budget proposal. As originally conceived, the fund would be administered by the U.S. Treasury Department and could be used as a source for outcomes payments or limited credit enhancement. In 2013, a Request for Information elicited varied feedback on the merits of the proposed fund and the PFS model in general from interested stakeholders. Responses are available here: [www.regulations.gov/docketBrowser?rpp=25&so=DESC&sb=commentDucDate&po=0&dct=PS&D=TREAS-DO-2013-000](www.regulations.gov/docketBrowser?rpp=25&so=DESC&sb=commentDucDate&po=0&dct=PS&D=TREAS-DO-2013-000)