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Big Society Capital Marks a Paradigm Shift

By Sir Ronald Cohen

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Ideas First Person

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The founding chair of Big Society Capital explains how the UK's social investment bank will harness entrepreneurship and capital to solve societal problems. BY SIR RONALD COHEN

HOW DO WE TRANSFORM the prospects of the socially disadvantaged? Answers to this question tend to focus on either the private sector or the public sector. But between the two sits the social sector, comprising charities, foundations, and other nonprofits that have distinctly social goals. There are 171,000 organizations in the social sector in the United Kingdom, holding total net assets of £95 billion and employing 668,000 people. For comparison, there were 987,000 public charities and 116,000 private foundations registered in the United States in 2009. Among them, they held more than $683 billion of charitable foundation assets and employed more than 9 million people.

At first sight, these aggregated numbers seem impressive. But the reality is that most charitable organizations are small and have no more than a few months of funding at their disposal. Yet there is one resource—vastly bigger than the resources currently available to either government or the social sector—that has remained largely untapped for social purposes: the capital markets.

Big Society Capital (BSC) was established with the belief that it is possible to tap into this huge pool of capital for social purposes, thereby transforming the prospects of the socially disadvantaged. In the process, the social sector can itself be transformed, provided that access to more capital is accompanied by a more supportive fiscal and regulatory environment. For that purpose, the sector needs to show a willingness to learn: It needs to offer a blend of measurable social and financial returns to attract investors; it needs to embrace financial innovation, including performance-based funding; and it needs to be more ambitious, seeking scale and efficiency. Importantly, charitable foundations and trusts need to make investments, in addition to grants, to achieve their social purposes. And the sector needs to attract and nurture innovative social entrepreneurs.

In the United Kingdom, leading organizations and individuals have been working to make all this happen since 2000. BSC is both our single biggest achievement to date and the intended principal catalyst for future accelerated change.

A Motivated Task Force

How has the UK arrived at BSC? First, there was a recognition across the political spectrum that the government-funded social safety net was not solving entrenched social problems. Furthermore, the condition of public finances following the economic downturn meant that government spending on social programs would be reduced.

ILLUSTRATION BY SCOTT ROBERTS

A number of us in the nascent sector of social investment proposed that, just as entrepreneurship has transformed business over the past 30 years, so social entrepreneurship could transform the way we deal with social issues. In the process, the latent need for capital on the part of social enterprises could be turned into expressed demand, thereby creating an emerging asset class.

The first step was the formation in 2000 of the Social Investment Task Force, which I chaired. Because social returns do not attract capital in the same way as financial returns do, the task force identified the need for a wholesaler of capital for the social sector, a "social investment bank." The bank would encourage and support the development of financial and investment intermediaries to fund frontline social sector organizations.

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It would blend social returns, financial returns, and tax incentives to attract finance from the capital markets. In parallel with these efforts, the government was looking for ways to release unclaimed assets from UK banks and to deploy them for the social good. The voluntary agreement reached between the Treasury and UK banks and building societies (cooperative savings groups) in July 2006 aimed to release funds from accounts that have been dormant for at least 15 years and where serious attempts to reunite the accounts with their holders have failed. The Commission on Unclaimed Assets, which I chaired, proposed in March 2007 that the funds should provide £250 million of equity for the social investment bank.

Yet the government was reluctant to release more than £75 million for this purpose. So in 2007, Lord Stanley Fink of the hedge fund Man, David Blood of Generation Investment Management, Philip Hulme, the entrepreneur behind Computacenter, a philanthropic family, and I contributed funding to establish the first social investment bank, Social Finance, to prove the proposition. We were then helped by the Rockefeller, Esmee Fairbairn, and Apax foundations and the Big Lottery Fund. Our case was strengthened when Social Finance developed and launched an innovative, social outcome-based investment security, the Social Impact Bond (SiB), in 2010.

The target population of the first SiB-funded program comprises 3,000 prisoners due to leave Peterborough prison over six years. In the United Kingdom, around 60 percent of short-sentenced prisoners are convicted of at least one offense in the year after release. Each short-sentenced prisoner who re-offended after release in 2007 was convicted, on average, of five further offenses within the year. We determined that a 7.5 percent reduction in re-offending over the life of the SiB-funded program—measured against a representative control group—would trigger a recoupment of capital and a 2.5 percent return to potential social investors. A sustained 10 percent reduction over the life of the program would result in an annualized return of 7.5 percent. Higher reductions of re-offending would deliver higher returns, subject to a maximum return of 13.3 percent. But if the measured improvement were to be less than 7.5 percent, the investors would lose their capital.

The SiB not only rewards social entrepreneurs for their success in delivering beneficial social outcomes, it also eliminates the state's risk: Government pays investors only if the targets are reached, and it pays less than 50 percent of the estimated cost to the justice system had the reduction in re-offending not been achieved. The concept of SiBs has created significant interest, not just in the United Kingdom but also in the United States, Canada, Australia, Israel, and now the European Union.

THE ROLE OF GOVERNMENT

A significant part of our effort since 2000 has been to ensure that we have the attention of government. Since both the Labour administration and the current coalition government accepted the idea of linking the social sector to the capital markets through a wholesale social investment bank, our efforts have risen above party politics. Soon after becoming prime minister in May 2010, David Cameron pledged that "every penny of dormant bank and building society account money allocated to England"—estimated to total between £400 million and £500 million—would be used to capitalize the equity of the organization. In addition, Barclays, HSBC, Lloyds, and RBS—the so-called Merlin Banks—have agreed to support the effort with £200 million of equity, so that BSC is starting with £600 million of equity capital that will flow to it over the next three or so years.

BSC's role is to develop the market for investments that are made on the basis of generating positive social impact as well as a spectrum of financial returns, going from low returns to market returns. In so doing, it will boost the ability of social enterprises to deal with social issues. BSC support will include investing in financial intermediaries that advise and invest in the social sector, and acting as a cornerstone investor in the social investment funds they launch; helping these intermediaries to grow in scale, so that they can effectively finance the growth of frontline social sector organizations; investing in organizations that provide the necessary infrastructure for significant development of the social investment market, such as a social stock market; and investing in and underwriting innovative financial products such as SiBs that help link social entrepreneurs and organizations to the capital markets. BSC has an additional important role to play as a champion for the development of social investment and the embedding of social impact measurement in the social sector.

Under CEO Nick O'Donohoe (formerly of J.P. Morgan and Goldman Sachs), with whom I advised government on these issues and with whom I am working now to establish BSC, the organization is already tackling many challenges, including attracting and keeping a motivated, expert management team; encouraging investment readiness among frontline organizations in need of capital; managing the expectations and concerns of existing social sector organizations that might feel threatened by the new models of organization and intervention; supporting the efforts of larger social organizations to shift to more sustainable models of revenue generation; securing tax incentives for investors in the sector; and supporting the implementation of similar measures at the international level, so that the social sector gains momentum from several countries.

Designing and establishing BSC took up much of 2011. We had to ensure that its governance structure made it independent of government but accountable and transparent, and that it had a sustainable business plan acceptable to government and the shareholder banks. Only then could we secure its funding and a talented board and management team to lead it.

The launch of BSC brings us closer to a transformation in the way society deals with social issues. Will social enterprise render philanthropy obsolete? No. There are many situations in which the philanthropic approach will always be more suitable than the impact investment approach—for example, where no clear social performance metrics can be applied, where community organizations are small and local, where the risk is too high, or where the financial returns are significantly too low for investors. Philanthropy, specifically venture philanthropy, also can play a crucial role in helping to leverage in capital, and it can be especially valuable to support innovation.

Over the last three decades, venture capital and entrepreneurship have transformed the mindset of investors, government, and mainstream business. By driving social entrepreneurship and innovation and significantly increasing the flow of capital, BSC aims to achieve a similar paradigm shift in the social sector. ■