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IFISE Innovative Financial Instruments in support to the Social Economy

Handbook

Financial Instruments for Social Impact

Supported by ERDF and ESF

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Introduction

Funding gaps particularly affect organisations such as social enterprises which are often appointed by public administrations that provide social services. The IFISE project is looking to identify innovative financial instruments that can also use European Structural and Investment (ESI) Funds to address unmet financing needs of the social economy.

This handbook offers clear guidelines for public administrations interested in designing and setting up financial instruments that positively impact society. It draws a roadmap to help navigate existing methodologies, tools and metrics for Social Impact Investment (SII). In addition, best practice examples highlight how to manage financial instruments with a social impact.

An overview of SII and its options under ESI Funds is given in Chapter 1. Chapters 2 and 3 are dedicated to analysing Social Impact Bonds (SIBs) and Social Impact Funds (SIFs) respectively.

The three chapters are designed to be standalone documents. The handbook can be read as a whole or each chapter can be consulted as needed.

The ***first chapter*** introduces the reader to four elements of SII:

- Key features: covers SII in the context of ESIF;
- Market assessment: reviews 'market failure' which is the rationale for intervention, the social needs and comparative advantages of SII;
- Delivery and management: highlights delivery elements such as the technical features of SII instruments, co-investment and State aid issues;
- Impact measurement: analyses the theoretical basis and options for measurement.

The other chapters replicate this structure. The ***second chapter*** offers a comprehensive analysis of SIBs in the European context. In addition to key topics it highlights the possibility of using ESIF resources, potential public and private investors as well as other stakeholders. It also covers governance models and implementation arrangements, public procurement and measurement methodologies.

The ***third chapter*** focuses on SIFs and includes subchapters on investment strategy, equity and quasi-equity investments, assessing added value, policy coherence within ESIF and crowdfunding.

Each chapter aims to offer operational insights with tables, figures and four categories of boxes:

- **Definition:** explains a concept, a tool, a measure;
- **Detail:** gives additional specific details;
- **Example:** illustrates real cases;
- **Checklist:** highlights key points.

List of Acronyms

CPR	Common Provisions Regulation
CSR	Corporate social responsibility
DG EMPL Policy	The European Commission Directorate-General for Regional and Urban
EaSI	Employment and Social Innovation
EC	European Commission
ECB	European Central Bank
EFSI	European Fund for Strategic Investments
EIB	European Investment Bank
EIF	European Investment Fund
ERDF	European Regional Development Fund
EuSEF	European Social Entrepreneurship Funds
ESF	European Social Fund
Eurostat	European Statistical Office
ESIF	European Structural and Investment Funds
EVPA	European Venture Philanthropists Association
GBER	General Block Exemption Regulation
GBP	British pound sterling
GIIN	Global Impact Investing Network
G8	Group of Eight
G20	Group of Twenty
IFISE	Innovative Financial Instruments in support to the Social Economy
MRA	Multi-regional assistance
NGO	Non-governmental organisation
NEET	Not in Education, Employment, or Training
OECD	Organisation for Economic Co-operation and Development
P2P	Peer-to-peer
ROE	Return on equity
RPA	Revenue participation agreements
SME	Small and medium-sized enterprise
SIB	Social Impact Bond
SIF	Social Impact Fund
SII	Social Impact Investment
SROI	Social Return on Investment
SWOT	Strengths, Weaknesses, Opportunities and Threats
TFEU	Treaty on the Functioning of the European Union
UN	United Nations

01
Social investment and ESIF financial instruments

01 Social investment and ESIF financial instruments

1.1 Key features

In today's economic environment, social challenges have increased while public funds in many countries are under pressure. In the EU, years of economic crisis and difficulties have put public budgets under pressure, enforcing the need to improve the efficiency and effectiveness of public policies. New investment approaches are required to address social challenges, including new models of public and private partnership. Innovation has started in some G8 countries (most notably the United Kingdom and the United States) with new social investment models, while governments, foundations, investors and other stakeholders are accelerating the market in other countries as well.

Governments increasingly encourage more effective ways to address social challenges and are open to innovative approaches from the private sector. This includes the public sector being a catalyst for social investment by creating a regulatory environment that encourages transparency and helps develop the market.[1] However, actions in one country or region may not be appropriate for another, so specific policy objectives and the local context must be considered.

This has encouraged increased social investment in recent years, addressing social needs while developing innovative financial solutions to social issues with new financing models emerging at multiple levels.

Many EU countries have social enterprises that are looking for innovative ways to tackle social challenges through market mechanisms. Despite an incomplete regulatory framework in Member States (see 1.2.1) these enterprises need capital to pursue their objectives and often face greater obstacles than do mainstream businesses. They often need technical assistance to become investor-ready, structure their financing and develop plans to scale their business models. Here public administration and phil-

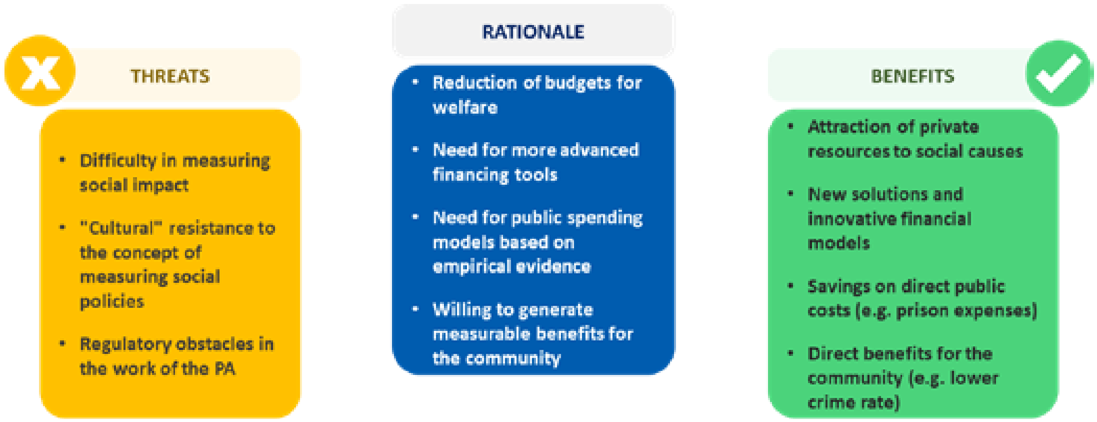
[1] See: Wilson, K. E. (2014), 'New Investment Approaches for Addressing Social and Economic Challenges', OECD Science, Technology and Industry Policy Papers, No. 15, OECD Publishing. http://dx.doi.org/10.1787/5jz2bz8g00jj-en

anthropic support is important to developing a market where competition is often imperfect, with high transaction costs and which also lacks advisors, exchanges and other market mechanisms.

New solutions to social challenges include a shift to models based on empirical evidence of public spending and a desire to create measurable benefits for the community and the environment.

As summarised in **Figure 1.1**, benefits include attracting private capital to social causes, new solutions and innovative financial models, as well as reduced public spending. The main issues, however, lie in the difficulty of measuring impact, a lack of financial knowledge in the social sector, as well as 'cultural' and regulatory obstacles in working with public authorities.

Figure 1.1: Rationale, risks and benefits of Payment by Result



Source: t33 elaboration

1.1.1 What is Social Impact Investing (SII)?

SII seeks to generate social impact alongside financial return. Such investments often bring together capital and expertise from the public, private and not-for-profit sectors to achieve a social objective.

SII has received increasing attention from international organisations (e.g. OECD, G8, G20) and national governments. This growing interest has been fuelled by many recent examples of good practice.

SII means investment in an activity, organisation or fund that generates both social and financial returns. Social investments can look for 'impact first' or 'finance first' returns and even though the title is 'social', it sometimes includes environmental or cultural impact. A definition of SII has been provided from the OECD and the Global Impact Investing Network (GIIN).

Box 1.1: Definition

Social Impact Investing

'The provision of finance to organisations addressing social needs with the explicit expectation of a measurable social, as well as financial return'

Source: OECD (2015), 'Social impact investment – Building the evidence base'

> *'Investments made into companies, organisations, and funds with the intention to generate a measurable, beneficial social or environmental impact alongside a financial return'*
>
> Source: The Global Impact Investing Network (2017)

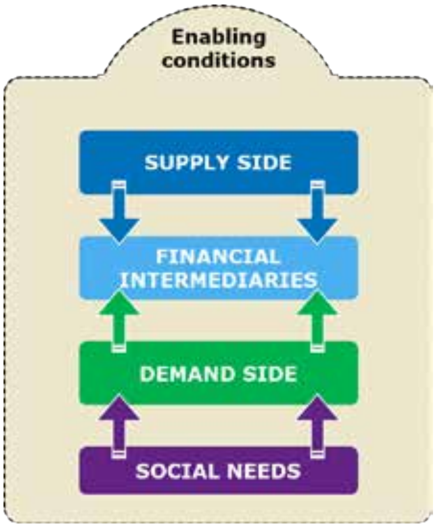
According to GIIN, SII has four main features:

- **Intentionality** – The investor is looking to generate social and/or environmental impact through investment.
- **Investment with return expectations** – Impact investments are expected to generate a financial return and, at a minimum, a return of capital.
- **Range of return expectations and asset classes** – Impact investments generate returns that range from below market ('concessionary') to risk-adjusted market rates.
- **Impact measurement** – The investor requires measurement and reporting of the social and environment al performance and progress of underlying investments.

In understanding SII it is very important to identify the whole framework and logic of interventions. The OECD identified the following elements:

1. **Social needs**: providing the basis of action, these include ageing, disability, health, children and families, affordable housing and employment.
2. **Demand-side**: service delivery organisations (or in some cases, individuals) such as community organisations, charities or non-profit organisations, social enterprises, social businesses and social impact-driven businesses.
3. **Supply side**: social investors providing capital in return for financial as well as social goals. Typical social investors are foundations and philanthropists. Among philanthropists, high net worth individuals can act alone or as investment groups.
4. **Intermediaries**: central to the impact investment ecosystem, they can be 'mainstream' (commercial banks, investment banks, independent financial advisors, brokers) as well as new specialist intermediaries (e.g. social venture capitalists, social stock exchanges, ethical-social banks as well as social financial vehicles or platforms).
5. **Enabling conditions**: the national/ regional enabling conditions or environment underpinning the SII market. These include the regulatory framework, private capital availability, the fiscal system and technical/financial know-how.

Figure 1.2: SII (OECD framework)



Source: t33 elaboration

1.1.2 Financing mechanisms

Although SII can make use of 'traditional' financing schemes and products, in recent years authorities and financial institutions have increasingly explored the use of innovative delivery tools. These were first used outside the ESIF context but are now becoming widespread among structural funds and in the framework of EU Cohesion Policy.

Traditional financing schemes include products that deliver financial instruments under ESIF[2]:

LOAN: an agreement which obliges the lender to make available to the borrower an agreed sum of money for an agreed period and under which the borrower is obliged to repay that amount within the agreed time.

GUARANTEE: A written commitment to assume responsibility for all or part of a third party's debt or obligation or for the successful performance by that third party of its obligations if an event occurs which triggers the guarantee, such as a loan default.

EQUITY: Provision of capital to a firm, invested directly or indirectly in return for total or partial ownership of that firm and where the equity investor may assume some management control of the firm and may share the firm's profits.

QUASI-EQUITY: Financing that ranks between equity and debt, having a higher risk than senior debt and a lower risk than common equity. Quasi-equity investments can be structured as debt, typically unsecured and subordinated and in some cases convertible into equity, or as preferred equity.

[2] Source: EC Regulatory Guidance (Guidance for Member States on financial instruments - Glossary): https://www.fi-compass.eu/publication/ec-regulatory-guidance/ec-regulatory-guidance-guidance-member-states-financial

These four financial products are mentioned in the 2014-2020 EC Common Provisions Regulations (CPR)[3] and can be used in designing and implementing financial instruments. It is worth underlining that the financial *product* and the *instrument* do not coincide. The financial instrument is defined in the CPR as a *form of support* that incorporates the use of the selected product, its combination with other forms of support such as grants, and the chosen implementation option.

SII can make use of these 'traditional' products, such as an SIF combining grants and equity products (see chapter 3). However, the SII delivery mechanism has to include measurement of the social needs, and of the social outcomes and impact, which are a key-challenge in the process. For this reason, SII can use more innovative delivery mechanisms, that may not be financial instruments. The EU regulatory framework acknowledges the use of outcome-based payments for grants and repayable assistance. Article 67 of the CPR lists the forms of grants and repayable assistance and among them, standard scales of unit costs, lump sums (not exceeding EUR 100 000 of public contributions) and flat-rate financing. These are 'Simplified Cost Options', that can be outcome-based, i.e. the payment can be linked to achieving outputs and results.[4]

The Payment by Result mechanism is being increasingly used, and ESIF authorities are examining options of this in the social economy. The mechanism foresees a payment, or premium, proportional to the social outputs, outcomes (or results) and the social impact that have been reached and measured.

Although the concepts of output, outcome (or result) and impact are illustrated in chapter 1.4, it is important to note that while outputs are tangible products or services that result from the financed activities, outcomes (or results) are the changes, lessons or other effects that result from these activities. Eventually, the impact is a broader and longer-term outcome that can be attributed exclusively to that intervention, excluding the actions of other interventions and unintended consequences.

Box 1.2: Example

Outcome in education

In a service to reduce early school leaving, an output can be the number of training courses and an outcome the % reduction of young students leaving school early. An impact would be the lower share of young students leaving school early that is directly generated by the financed activities. This should exclude, for example, the influence of any better and more efficient educational offer in the target region or country that is not generated by the financial activities, or a more efficient government advertising campaign in favour of continued education.

The Payment by Result concept is being used more and more due to several factors. These include cuts to public spending, increasing demand for innovative financing tools, models based on empirical evidence in public spending and measurable benefits for the community and the environment.

[3] REGULATION (EU) No 1303/2013 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 17 December 2013, and fi-compass 'EC Regulatory Guidance (Guidance for Member States on financial instruments - Glossary)': https://www.fi-compass.eu/publication/ec-regulatory-guidance/ec-regulatory-guidance-guidance-member-states-financial

[4] As explained in the EC guidance on Simplified Cost Options: https://ec.europa.eu/regional_policy/sources/thefunds/fin_inst/pdf/simpl_cost_en.pdf

The main benefits of Payment by Result relate to the use of private capital for social causes, new solutions and innovative financial models, reduced public spending and direct positive consequences for society.

The main issues, however, lie in the difficulties of measuring the impact, cultural differences and regulatory obstacles in working with public authorities.

Payment by Result allows administrations to pay public service providers based on achievements, which transfers the financial risk to the supplier. Under this scheme and especially in the Anglo-Saxon public policy context, **SIBs** have become increasingly important in recent years.[5] Significant examples include the reintegration of former convicts in Peterborough (UK), therapeutic services for prisoners in Rikers Island (USA), and YMCA support for youth employment in Scotland.

Payment by Result has captured wide-spread interest across the world and SIBs have been set-up to tackle complex social issues such as refugee employment support, loneliness among the elderly, re-housing and reskilling homeless youth, as well as diabetes prevention.

Other innovative financing mechanisms for the social economy are illustrated in the table below.

Table 1.1: Financing mechanisms for the social economy

Instrument	Characteristics
Charitable / Retail charity bonds	Philanthropic institutions and social service providers can issue bonds as a form of long-term debt financing, given prospective revenues that can repay investors. Retail Charity Bonds is a London Stock Exchange listed platform that supports the issuance of charitable bonds. It has enabled two social impact organisations to issue over EUR 45 million of bonds destined for social housing initiatives.
Investment Funds	Terminology and definitions often vary between countries, but investment funds can be referred to as investment pools, collective investment vehicles, collective investment schemes, managed funds, or simply funds. These funds are for collective investment, normally short-term or in transferable securities. Investors can include the public through mutual funds, exchange-traded funds, special-purpose acquisition companies or closed-end funds. For a private placement, investors can be hedge funds and private equity funds. Investment funds have a wide range of aims including specific geographic regions (e.g. emerging markets or Europe) or industry sectors (e.g. technology). For more detail on SIFs (a form of investment funds), see Chapter 3.
Microfinance/ microcredit	Small loans with no collateral and accompanied by tutoring/coaching services for the borrower. These loans can be to small enterprises (to sustain micro entrepreneurship), non-profit organisations (both associations and cooperatives) and individuals in vulnerable economic conditions. The global microcredit market has more than 200 million clients worldwide and includes over 3 000 microcredit institutions.
Revenue participation agreements (RPA)	RPAs are quasi-equity instruments that entitle the buyer to a predetermined percentage of revenues up to a multiple of the invested capital. They are particularly suited to financing non-profit organisations as they avoid selling equity to external investors. Moreover, they allow investors to share risks and benefits while providing patient capital at more flexible conditions than traditional debt. RPAs are mostly found in the UK with impact investors such as Bridges Ventures, Big Issue Invest, CAF Venturesome, or Social Investment Businesses.
Social bonds	Social bonds are issued by financial institutions to raise capital for social interest initiatives. The issuing institution supports such initiatives through grants or debt financing (at favourable conditions). Investors in social bonds are remunerated with financial returns, while supporting initiatives with a positive social impact.
Social Impact Bonds	An SIB is a contract with a public sector authority which pays for better social outcomes and uses savings to pay investors who funded the initiative. The cost of funding varies as public institutions pay the bond issuer for measurable savings given agreed social outcomes. At the end of 2016, 60 SIBs had been issued all over the world according to Social Finance (UK). This had increased to 89 SIBs in more than 20 countries by January 2018. For more detail, see Chapter 2.

5 For an extensive analysis of SIBs, see chapter 2

1.1.3 ESI funds and SII

EU policies have increasingly focused on the social economy in recent years. The European Commission's Social Business Initiative was launched in 2011 and remains a reference for SII and support for social enterprises under ESIF.

Investments in the social field are integral to the 2014-2020 programming period, also through specific investment funds like the European Social Entrepreneurship Funds (EuSEF). In both 2007-13 and 2014-2020, a growing number of regional and national administrations have decided to implement financial instruments with a social purpose, thanks to support from the European Social Fund (ESF) and, in some cases, the European Regional Development Fund (ERDF). As of 31 December 2017, managing authorities in seven Member States had started ESF financial instruments, with EUR 557 million of contributions from Operational Programmes (of which EUR 361 million was from ESF).[6]

In the ESIF context financial instruments have three major advantages:

1. **Leverage.** In addition to ESIF financing, financial instruments may attract other resources, both public and private.
2. **Revolving.** Through repayments or the realisation of investments, additional flows of money can be reused by managing authorities.
3. **Increased quality** of projects, as the investments must generate revenue to be repaid.

Box 1.3: Definition

Definitions of ESIF financial instruments

'Union measures of financial support provided on a complementary basis from the budget to address one or more specific policy objectives of the Union. Such instruments may take the form of equity or quasi-equity investments, loans or guarantees, or other risk-sharing instruments, and may, where appropriate, be combined with grants'

Source: EC Regulatory Guidance (Guidance for Member States on financial instruments - Glossary)[7]

In achieving social impact, financial instruments may contribute to improving living conditions for disadvantaged people since they can:

- Enhance social services in key sectors such as employment, health, ageing, education, housing and family services;

[6] European Commission, 'Financial instruments under the European Structural and Investment Funds - Summaries of the data on the progress made in financing and implementing the financial instruments for the programming period 2014-2020 in accordance with Article 46 of Regulation (EU) No 1303/2013 of the European Parliament and of the Council'.
See https://ec.europa.eu/regional_policy/sources/thefunds/fin_inst/pdf/summary_data_fi_1420_2017.pdf

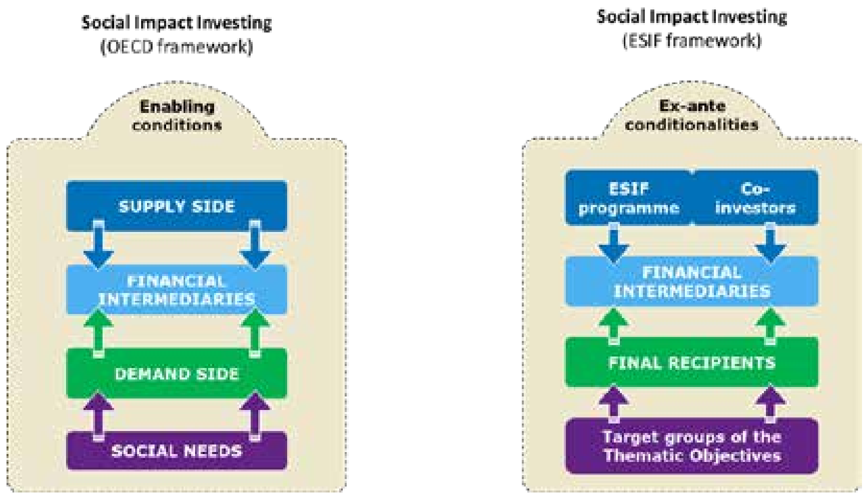
[7] fi-compass, EC Regulatory Guidance (Guidance for Member States on financial instruments - Glossary): https://www.fi-compass.eu/publication/ec-regulatory-guidance/ec-regulatory-guidance-guidance-member-states-financial

- Empower individuals by assuring 'financial citizenship' and capital stability. Typically, underprivileged people access financial services through the 'informal economy', which might be dangerous and inefficient;

- Support entrepreneurship and then self-sufficiency, since they support revenue-generating activities.

In the framework of ESIF, the key actors and conditions of SII as described in the OECD framework can be seen in the following figure:

Figure 1.3: SII working with ESIF



Source: t33 elaboration

- The figure shows that the ex-ante conditionalities of ESIF programmes may ensure SII **enabling conditions,** as previously explained (see par. 1.1);

- Operational Programmes are part of the **supply side**, i.e. the party providing the financing, together with co-investors;

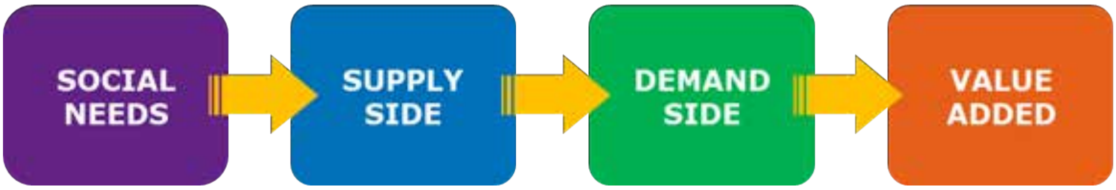
- final recipients are the **demand side**, the target for financial support;

- the eleven EU Thematic Objectives represent **social needs** to be addressed for the benefit of communities. Furthermore, the specific objectives define vulnerable target groups, as well as areas or sectors of intervention.

1.2
Market assessment

A market assessment is evidence to justify and design an investment. The assessment requires a definition of the social needs and target groups, then continues with an analysis of demand, supply and value added.

Figure 1.4: Process of market assessment



Source: t33 elaboration

For the EU 2014-2020 programming period, under EU Regulation 1303/2013 (article 37), a market analysis is required as part of the ex-ante assessment for financial instruments. The ex-ante for financial instruments has two blocks, one with the market analysis (and a determination of the value added) and one outlining the envisaged delivery and management of the instrument.

Although a mandatory structure for the 2021-2027 programming period is currently under debate[8], the rationale and logic of the market analysis supports evidence-based decision making for authorities willing to design and implement financial instruments.

1.2.1 Demand

Market failures, suboptimal investment situations in the social economy

According to the structure of the ex-ante assessment, public intervention is justified by market failures and suboptimal investment situations creating unmet investment needs (gaps). Identifying these elements enables assessment of additional public investment needs and the potential added value of financial instruments.

Identifying market failures that could be addressed with ESI fund financial support requires defining needs under the Operational Programme. Different problems or failures affect different objectives. As described in Sub-chapter 1.1, SII works on specific social needs, including those linked to ageing, child

[8] See article 52 of the 'Proposal for a Regulation of the European Parliament and of the Council laying down common provisions on the European Regional Development Fund, the European Social Fund Plus, the Cohesion Fund, and the European Maritime and Fisheries Fund and financial rules for those and for the Asylum and Migration Fund, the Internal Security Fund and the Border Management and Visa Instrument', Strasbourg, 29.5.2018.

care, affordable housing, education, support for women, migrant support, health care and assistance for disadvantaged people and the unemployed (including NEETs[9]).

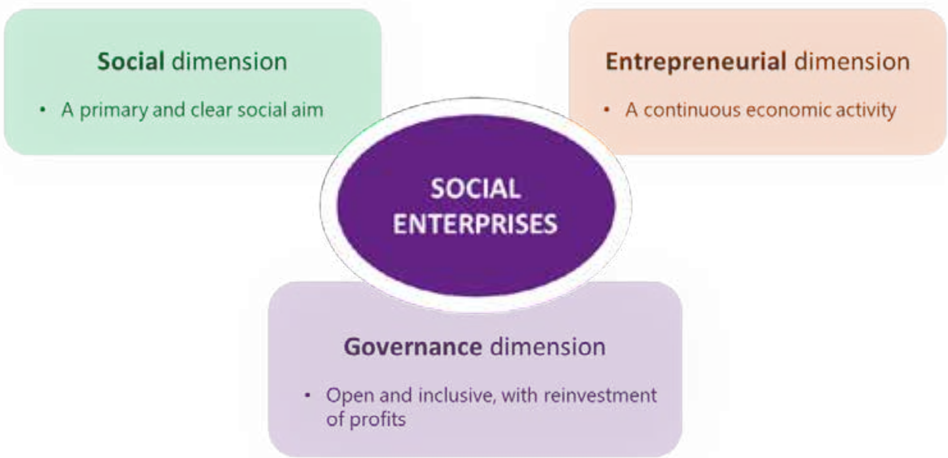
Moreover, *financial exclusion* can be described as the 'process whereby people encounter difficulties accessing and/or using financial services and products in the mainstream market that are appropriate to their needs and enable them to lead a normal social life in the community in which they belong'[10]. This definition can be extended from 'people' to social economy enterprises and organisations, including new or existing entrepreneurs with credit needs and nearly bankable businesses.

Social enterprises

A definition is provided by the EC: 'A social enterprise is an operator in the social economy whose main objective is to have a social impact rather than make a profit for their owners or shareholders. It operates by providing goods and services for the market in an entrepreneurial and innovative fashion and uses its profits primarily to achieve social objectives. It is managed in an open and responsible manner and, in particular, involves employees, consumers and stakeholders affected by its commercial activities.[11]'

So, three dimensions are provided by the EC to define social enterprises: a social dimension (i.e. an explicit and primary social goal), an entrepreneurial dimension (the economic activity has to be continuous) and a governance dimension (that should be open and inclusive, while profits are reinvested for social purposes rather than redistributed).

Figure 1.5: Three dimensions of social companies



Source: t33 elaboration

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[9] A NEET is a person who is 'Not in Education, Employment, or Training'. The acronym first appeared in the United Kingdom and is now used in many countries, usually to define people with the above characteristics and aged between 16 and 24.

[10] European Commission (2008), Financial services provision and prevention of financial exclusion, Directorate-General for Employment, Social Affairs and Equal Opportunities Inclusion, Social Policy Aspects of Migration, Streamlining of Social Policies

[11] European Commission COM (2011) 682 final, 'Social Business Initiative – Creating a favourable climate for social enterprises, key stakeholders in the social economy and innovation', p.2.

According to the EC Directorate-General for Employment, Social Affairs and Inclusion, social enterprises can have a broad range of activities or social missions including:

- Social and economic integration of disadvantaged and excluded people, such as work integration and sheltered employment, including training and skills development for marginalised and unskilled people;
- Social services such as long-term care for the elderly and for people with disabilities, education and child care, employment and training, social housing, health care and medical services;
- Other public services such as community transport, or the maintenance of public spaces;
- Strengthening democracy, including civil rights and digital participation;
- Environmental activities such as reducing emissions and waste, or promoting renewable energy;
- Practising solidarity with developing countries.

The sectors in which social enterprises are active differ significantly between EU Member States. The main sectors relate to social services, employment, training and education, the environment, and economic, social and community development, while health, housing, business associations, law and advocacy are less common.

Access to finance is a key challenge for social enterprises. Traditional financing sources often consider them as higherrisk and less profitable than other businesses, due to constraints on their redistribution of profits, their employment of vulnerable workers, or simply due to a restricted knowledge of the social market. Therefore, social enterprises more than other businesses must deal with gaps in the financial markets.

Although in some Member States social enterprises are changing their business model to have a stronger focus on entrepreneurial activity to achieve social missions, this category of companies lacks a specific policy and regulatory framework in most EU Member States, which makes it hard to access public funds, as described below.

Box 1.4: Detail

EU Regulatory environment for social enterprises

Most EU Member States do not have a specific policy framework for social enterprises. However, as at 2014, 16 Member States had some form of legislation that recognised and regulated the activity of social enterprises to some degree.

These regulations highlight three broad approaches to social enterprises:

- Adapting existing legal forms to cover social enterprises as cooperatives, or companies;
- creating a social enterprise legal status;
- recognising specific types of non-profit organisations with economic activity – although not labelled as such, these can be social enterprises

Authorities looking to establish a financial instrument with social impact should analyse the demand side in their region/country as highlighted in the figure below.

Figure 1.6: Three dimensions of social companies

Source: t33 elaboration

A detailed explanation of how to apply this procedure of market assessment to an SIB and an SIF is in Chapters 2 and 3 respectively. Below is a methodology for calculating a financial gap in support for social enterprises.

Financial gap

Estimating potential unmet demand for financial resources in the social sector can be challenging, mainly due to data availability. One method is based on the established methodology used by the EC, with input from the European Investment Bank (EIB) and the European Investment Fund (EIF) in 2013[12]. This involves estimating the number of social enterprises not obtaining a loan, while being financially viable and thus apparently creditworthy. Multiplying this number by the average enterprise's loan amount gives an estimate of the unmet financing needs for financially viable enterprises.

The EC methodology not only highlighted an average EU-wide gap for SMEs of EUR 20 billion to EUR 112 billion, for 2009-2012, but it also underpinned the rationale of the SME Initiative and contributed to its design. The methodology structure is described in the following box[13].

Box 1.5: Detail

Methodology structure

Loan financial gap =
No. of **Total** enterprises
OF WHICH: **Financially viable** enterprises **(A)**
OF WHICH: **Unsuccessful** enterprises **(B)**
MULTIPLIED BY the **average loan** for enterprises **(C)**

Where:

A. Financially viable enterprises are enterprises with turnover growth.

[12] European Commission (2013), 'Ex-ante assessment of the EU SME Initiative', Brussels, 5.12.2013 SWD (2013) 517 final.

[13] Ibidem, and *fi-compass.eu,* 'factsheet: financial gap in the EU agricultural sector'

The EC methodology defines two boundaries:

1. The lower boundary is high-growth enterprises, i.e. with turnover growth of at least 20% in the previous three years;
2. The upper boundary is enterprises with positive turnover growth in the previous six months.

B. Unsuccessful enterprises is the share of financially viable enterprises that did not obtain a loan.

This is calculated as follows:

Unsuccessful enterprises = [enterprises that applied × (enterprises rejected + enterprises refused)] + enterprises discouraged

Where:

- Enterprises that applied = share of enterprises that applied for a bank loan;
- Enterprises rejected = share of enterprises that applied for a bank loan whose demand was rejected by the bank (bank rejection);
- Enterprises refused = share of enterprises that applied for a loan but faced unacceptable costs, i.e. high interest rates (enterprise rejection);
- Enterprises discouraged: share of financially viable enterprises that did not apply for a loan for fear of rejection (enterprise unwilling);

B. Average loan size: loans granted to enterprises (in EUR).

The equation in the SME Initiative ex-ante assessment details how to calculate a financial gap for loans, which can help a decision on the use of financial instruments.

This methodology can be applied to social enterprises, depending on data availability and a clear classification of social enterprises (see above) in the region or country.

1.2.2 Supply

In recent years SII has rapidly evolved in Western countries with 'traditional' financial institutions, such as investment banks, fund managers and even individuals entering the social market. In addition, new types of institution and new financial technologies ('fintech') such as crowdfunding and peer-to-peer (P2P) lending have also had an impact. So, the options to address social and financial needs are steadily growing. With these opportunities, many countries and foundations have played a decisive role in the shift from grant-based social investments to revolving investments.

Freireich and Fulton[14] classify impact investors based on their primary objective:

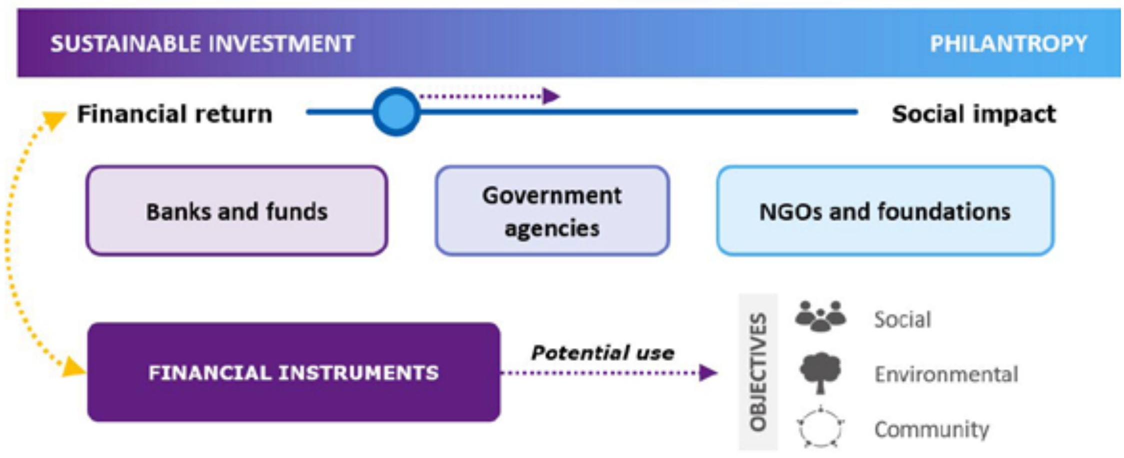
1. **'Impact first' investors – seek to optimise social impact with some financial return**. This group aims to generate social good and is willing to sacrifice parts of the financial return if necessary (to increase the social return).

[14] Freireich, J., and K. Fulton, Investing for social and environmental impact, 2009.

2. **'Finance first' investors – seek to optimise financial return with some social impact**. This group is made up mainly of commercial investors who target subsectors that guarantee a market-rate financial return while also achieving social objectives, or that include social and environmental criteria in their investment decisions (but without decreasing their financial return).

Moreover, they claim that 'impact first' and 'finance first' investors can cooperate (through a so called 'ying-yang' deal) in spite of their different purposes and risk-return appetites.

Figure 1.7: 'Finance first' vs 'impact first' investors



Source: t33 elaboration

Innovative social investors

For a potential SII intervention, market analysis of the supply side should focus on traditional financial actors, but also consider potential new players in the country/region, such as:

- Social Venture Funds: with a similar portfolio approach as traditional venture capital funds, who balance risks and returns of investments in the social economy. An example is the Ananda Social Venture Fund (Germany) that manages three funds totalling EUR 80 million[15], targeting social enterprises and deliberately not investing in enterprises directly or indirectly related to nuclear energy, defence and weapons, or addictive substances.

- SII financial institutions: a very successful example is Big Society Capital (UK), an independent financial institution founded in 2012. The institution has social investments of GBP 1.7 billion, of which GBP 0.5 billion is from its own capital.

- Social business angels: wealthy individuals are increasingly interested in SIIs. Their contribution can be augmented by dedicated networks, such as PYMWYMIC (Put Your Money Where Your Meaning Is Community) in the Netherlands, through which they often contribute not only money, but also their business know-how.

[15] At 22 October 2018. See https://ananda.vc/#news

In addition to these, other types of financial institution are being 'tested', such as the 'social stock exchange', demonstrating the search for new social economy models. When approaching investors, financial intermediaries and managing authorities need to demonstrate the scope of the social impact instrument. In addition, an investment strategy should undergo a preliminary compliance check with the national and EU regulative framework. In the box below, a check list highlights an approach for financial investors.

Box 1.6: Checklist for social investors

Overall purpose and scope

- The desired balance between financial and social outcomes (i.e. expected internal rate of return? What is the expected social internal rate of return? What financial risk is acceptable?).
- Added value of the initiative compared to other initiatives
- Expected results
- Sector, target population, geographical area clearly identified and, possibly, quantified.

Investment strategy / business plan

- A market assessment estimating the financial gaps.
- The financial product and lending / pricing policy
- Risk / revenue sharing strategy (e.g. pari passu)
- Result indicators
- Impact measurement system
- Governance (identified implementing body, key social, financial and other partners)
- Total public resources available and the sources (ESF? ERDF?).
- Possible synergies with other activities

Compliance

- Regulatory changes that may affect the initiative
- State aid and public procurement clearance

1.2.3 The role of financial intermediaries

Financial intermediaries are key to SII as they link investors and final recipients and balance the trade-off between social responsibility, financial returns and sustainability. They can also drive innovative solutions and explore new targets.

Box 1.7: Definition

Financial intermediaries

The European Central Bank (ECB) defines financial intermediaries as:

- **monetary financial institutions** – credit and non-credit institutions who receive deposits, grant credit and invest in securities.
- **other financial intermediaries** – corporations or quasi-corporations other than insurance corporations and pension funds that engage mainly in financial intermediation (leasing, vehicle corporations that hold securitised assets, financial holding corporations, dealers in securities and derivatives, venture and development capital companies).

Source: European Central Bank

Financial intermediaries can also vary in nature and geographic scope (see table below).

Table 1.2: Main features of financial intermediaries

Nature	**Bank**	**Non-bank**
	• Commercial banks • Credit unions • Cooperative banks • Savings banks	• NGOs or foundations • Social equity fund providers • Specialised microfinance intermediaries • Government bodies or agencies • Community development financial institutions
Geographic scope	**Multi-market intermediaries**	**Local intermediaries**
	• Operate in several markets • Less vulnerable to fluctuations (increased stability) • May lack an understanding of the specific needs of the region • Not reliant on subsidies or shareholder contributions (self-sustainable)	• Operate in one market (local or regional) • More vulnerable to macro-economic fluctuations • Advanced knowledge of the local context • Tend to require technical support for institutional capacity building
Mission	**Financial mission**	**Social mission**
	• Purely a profit-driven economic operator	• Aim to find investments that generate a return but also generate a social impact

Whatever their nature, geographic scope and mission, financial intermediaries should tailor financial instruments to specific social needs and the overall ecosystem. For example, when supporting start-ups or new entrepreneurship, financial intermediaries have to design specific products meeting needs and expectations of non-bankable individuals including 'non-financial support'. Whatever their nature, scope or mission, financial intermediaries dealing with SII need to have the social understanding and know-how to provide supplementary technical, financial and managerial advice.

Innovative financial intermediaries have an increasingly relevant role in the trade-off between demand and supply and include:

- P2P lending platforms: these enable people to lend and borrow money online, without using traditional financial institutions as intermediaries. They have lower overheads and normally cost less than traditional intermediaries. An example is Smartika in Italy, recently acquired by the banking institution Gruppo Sella.

- Social incubators and accelerators: which can support new small businesses through financial support or 'soft-support' such as services, equipment, technical assistance and access to a network of financial stakeholders. Examples include Social Incubator North and the Young Foundation, both in the UK.

- Crowdfunding platforms: digital platforms where users can choose among different projects to be funded by small amounts of money. While the amount is individually small, many contributions can gather significant amounts for each project.16

[16] See chapter 3.2.3 for more insights on crowdfunding

Public financial institutions

Public financial institutions can play an important role in SII, with their proximity and know-how. More importantly, they are normally more tailored for social missions given their territorial legacy. They can efficiently develop ad hoc instruments leveraging their existing place-based expertise and also adjust products and services to social targets. An overview of the comparative advantages of public financial institutions is shown in **Table 1.3**.

Table 1.3: Public financial Institutions: main advantages

Attribute	Description
Proximity to local market	Regional public financial institutions are close to the territories and have a specific territorial understanding, they can establish closer relationships with borrowers, their customers and suppliers, as well as with local business, ensuring face-to-face contact. They can also distinguish micro-differences in the region between urban and rural areas, industrial and service sectors, etc.
Adaptability of financial products for social investments	Proximity may help regional public financial institutions forge financial instruments tailored to the needs of local targets. More importantly, proximity also provides an advantage in channelling the products to the right target group.
Focus on investment sustainability	Despite being public bodies, the specific financial nature of regional public financial institutions entails a managerial discipline that is not always found in the social sector.
Understating social needs and focus on social mission	Capacity to understand and share the social mission and to comprehend that financial return may require more time with a higher level of risk.
Additional non-financial services	Regional public financial institutions can easily form local partnerships with specialised regional agencies (e.g. employment agencies), as well as local NGOs or third sector organisations, to offer services such as business development.

The EIB group

The EIB group includes the EIB and the EIF, which has played a steering role in SII, in particular through its Social Impact Accelerator. This pan-European public-private partnership addresses the growing need for equity finance to support social enterprises and reached a EUR 250 million target at its first closing. This fund of funds invests in social impact funds which strategically target social enterprises across Europe. To now, it has invested over EUR 100 million into 11 impact funds across Europe.

The EIF has developed three further types of SII instruments under the EFSI Equity Instrument that target:

- Investments in/or alongside financial intermediaries linked to incubators, accelerators, and/or that provide incubation services;
- Investments alongside business angels or investments in business angel funds;
- Payment-by-Results/SIB investment scheme.

Investments will be made from the two windows under the EFSI Equity Instrument, the Early Stage and the Expansion and Growth Stage windows.

For the EIB one of the most appropriate instruments for SII under ESIF is the Employment and Social Innovation (EaSI) programme. The third axis of the EaSI programme aims to:

- Increase access to, and the availability of, microfinance for vulnerable individuals or groups who want to set up or develop businesses and microenterprises.
- Build up the institutional capacity of microcredit providers.
- Support the development of social enterprises, by facilitating access to finance. Two financial products are tailored to public and private institutions. These are funded instruments, which include loans and equity and the EaSI Guarantee Financial Instrument, which provides capped guarantees and counter-guarantees covering loan portfolios in the microfinance and social entrepreneurship sector.

ESF financial instruments can be enhanced by the Microfinance and Social Entrepreneurship axis of EaSI through:

- More financial resources generating new job opportunities with self-employment for unemployed people and non-bankable individuals.
- Providing new financial instruments increasing institutional capacity for financial intermediaries providing microfinance that addresses social needs.
- More financial resources for social enterprise creation and expansion. The Microfinance and Social Entrepreneurship axis of EaSI is therefore particularly appropriate for Thematic Objectives 8 and 9.

1.2.4 Added value of SII instruments

Apart from the attracting funds, an estimation of added value for social investments should consider a wide range of factors. These can include investment in education for disadvantaged people that can generate positive short-term value (e.g. discouraging criminality) and medium-long term value (e.g. better employment opportunities) which generate future advantages such as increased tax and lower welfare costs. The same mechanism applies to all previously analysed target groups (e.g. interventions in health prevention lead not only to immediate benefits for the people in need, but also to long-term savings in healthcare expenditure).17

Determining the value added, as required in an ex-ante assessment for financial instruments, should include both the quantitative and the qualitative aspects of the envisaged instrument.[18]

To analyse the quantitative value added, it is useful to compare the proposed instrument with any other mechanisms such as grant schemes that, especially in the social economy, are used to tackle similar market failures. In assessing the valued added, at least the following factors should be examined:

[17] See JRC, Social Impact Investment in the EU, 2018

[18] See fi-compass, 'Ex-ante assessment methodology for financial instruments in the 2014-2020 programming period', volume I

- **The leverage of ESI funds**, i.e. how much additional contribution the instrument can attract (from other funds and from co-investors): more leverage means more value added.

- **Contributions from final recipients** (sometimes required), as they are not part of the leverage calculations but nonetheless increase the value added.

- **Less subsidies**: lower subsidies mean more value added.

- **The revolving effect**: returned funds that can be reused to increase the value added.

A review of potential value added from the two proposed schemes (SIB and SIF) is in Chapter 2 and Chapter 3.

Box 1.8: Example

Case study: first SIB in Austria – Specific target group

Social service providers in Austria created a customised programme for the **economic and social empowerment of women affected by violence.** The project supported women and children who had been victims of violence and, through employment, gave them the opportunity to become independent of violent relationships.

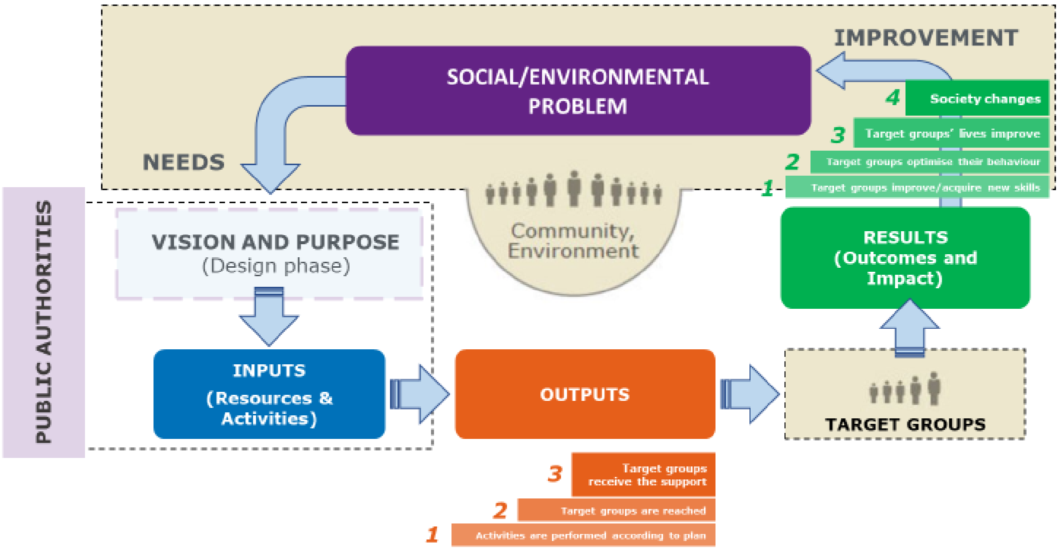
By offering a combination of **intensive psychosocial care and appropriate job placement**, many participants had opportunities to support themselves and escape abuse. Even though not all participants had a substantial income, the majority could **provide for themselves and their children** and escape abusive relationships.

A predefined target of the project was not fully achieved, so the Austrian Federal Ministry for Social Affairs did not have to refund the upfront financing from non-profit foundations. This complies with a prerequisite for an SIB, that **public funds are only used when targets are achieved**. Although the targets were not reached, the Ministry regards the project as a success based on the results and the lessons learned. Increased knowledge about the potential for aid programs with target-oriented funding provides a basis for improving and expanding.

1.3
Delivery and management

The intervention logic for SII involves several actors and public authorities with leading and strategic roles during design of the instrument, which includes choosing the most appropriate implementation options.

Figure 1.8: Intervention logic



Source: t33 elaboration

Once the need for SII has been established, authorities managing ESI funds then choose the delivery mechanism, public procurement process if relevant (which can include innovative selection criteria), and additional features such as combinations of support and non-financial services.

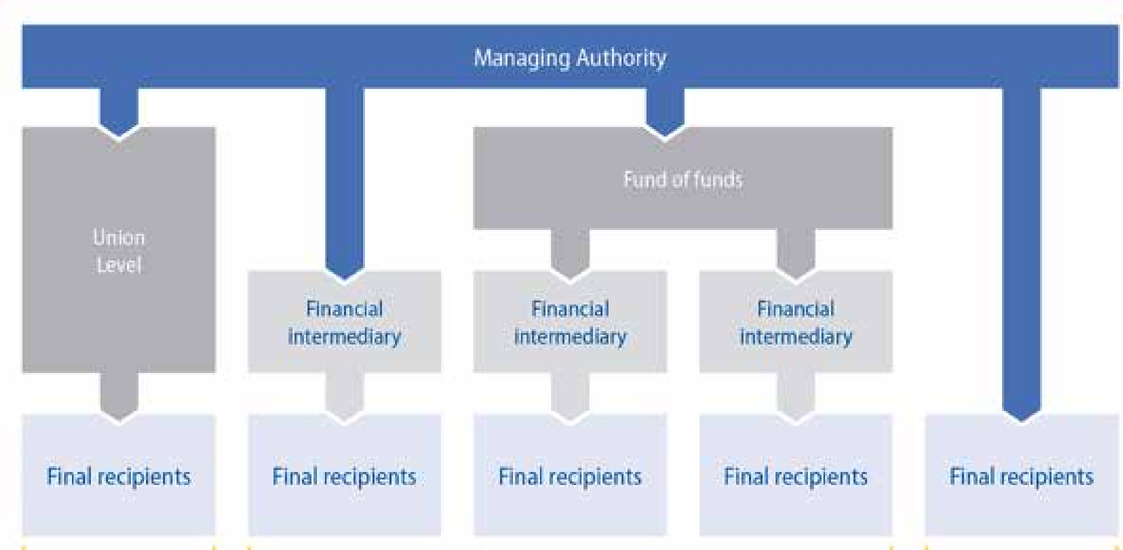
1.3.1 Implementation options

After the market assessment, the ex-ante assessment for financial instruments must provide an investment strategy consistent with the market along with an analysis of value added (see Sub-chapter 1.2). Authorities should also provide 'a specification of expected results and how the financial instrument concerned is expected to contribute to the achievement of the specific objectives' and 'provisions allowing for the ex-ante assessment to be reviewed and updated'19.

Standard implementation options in the current programming period are described in the following figure.

[19] EU Regulation 1303/2013, Article 38 (f) and (g).

Figure 1.9: ESIF financial instruments implementation options (2014-2020 programming period)



Source: fi-compass.eu, 'Developing an Action plan' factsheet

This handbook does not review in detail the options of financing at 'Union level' (e.g. through EU directed programmes such as Horizon 2020, Erasmus+, etc.) or directly to final recipients (an uncommon practice so far). Most financial instruments are implemented through one or more financial intermediaries, or a fund of funds manager. In either case, authorities need their own capabilities and resources. Depending on these, authorities can deal with one or multiple financial intermediaries.

With SII, the number of parties involved and the complexity of individual schemes, especially if innovative, can be higher. Managing authorities need to carefully consider the public procurement process. The number of intermediaries may be limited by managing authority resources available for this process and for signing separate funding agreements with each financial intermediary. Authorities must also manage on-going reporting and monitoring.

If resources are limited, a single contact point, such as a single financial intermediary or a fund of funds manager, may be the appropriate option. This can be especially relevant if financial instruments are new, the authority's expertise is limited, or the structure is complex.

1.3.2 Procuring the SII

Whenever there is a contract between a public authority and a private operator, it is important to **follow public procurement rules that ensure transparency, value for money and competition.**

The two fundamental aspects are the:

- legal framework (how to structure the contract between the public and private counterparts)
- procedures used to select the private counterpart.

SII can often include complex schemes with multiple co-investors and intermediaries, as well as innovative features. Within the EU framework a public-private partnership must allocate risks to economic operators, which accept the risk of losses in return for potential rewards. A counterpart with very little at risk has little incentive to reach the strategic goals.

For example, an SIB finances initiatives that look to reach specific strategic goals which the public authority could not solve without external assistance (see Chapter 2). This is different from contracting out a social service when traditional, easier and cheaper alternatives are available. That is why an SIB must be an incentives-based contract that transfers the risk to investors and service providers have incentives to reach the strategic goals. Public authorities may need more information before selecting financial intermediaries, and the regulations allow them to use innovative public procurement mechanisms[20].

Traditional mechanisms of *open procedure* (where anyone can respond to a call and submit a tender for a contract) and *restricted procedure* (where a selection is made from responses to an advertisement, and only those selected can submit a tender) are applied in standard cases. The new EU regulation on public procurement[21] established that for particularly complex purchases and under certain conditions, specific procedures such as a *competitive procedure with negotiation* and *competitive dialogue* may accommodate the specific needs of the contracting authority.

A competitive procedure with negotiation or a competitive dialogue can be used when the[22]:

- contracting authority needs cannot be met without adaptation of readily available solutions;
- needs include design or innovative solutions;
- contract cannot be awarded without prior negotiations because of specific circumstances related to the nature, complexity, or legal and financial make-up, or because of the risks attached;
- technical specifications cannot be established with sufficient precision by the contracting authority with reference to a standard, European Technical Assessment, common technical specification, or technical reference within the meaning of points 2 to 5 of Annex VII of the new EU regulation on public procurement.

So, the two procedures can be used when a standard procurement procedure fails, i.e. when only irregular or unacceptable tenders are submitted in response to an open or a restricted procedure[23].

It is important to underline that the contracting authority must assess whether 'specific circumstances' or conditions justify the use of these two procedures. Both procedures include a dialogue or a negotiation with selected tenderers, to develop more targeted solutions. The difference between the two is where this dialogue or negotiation happens. In a competitive dialogue procedure, this is before submission of final tenders. With a competitive procedure with negotiation, the contracting authority may reopen negotiations with selected tenderers after their submission, to seek improved offers.

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[20] For more detail on SIB and public procurement, please see Chapter 2.3.5

[21] Directive 2014/24/EU on public procurement

[22] Directive 2014/24/EU on public procurement, article 26

[23] European Commission, Guidance for Member States on the selection of bodies implementing financial instruments (2016) https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016XC0729(01)&from=EN#page=4

The regulation also enables an *innovation partnership procedure* for 'the development of an innovative product, service or work and the subsequent purchase of the resulting supplies, services or works'. This procedure involves successive phases mirroring the research and innovation process, (e.g. design, then provision of the service, then completion of the works). The innovation partnership sets intermediate targets to be reached by the partners and the authority pays the remuneration in instalments. Based on those targets, the contracting authority 'may decide after each phase to terminate the partnership or, in the case of an innovation partnership with several partners, to reduce the number of partners by terminating individual contracts'.[24]

Table 1.4: Public Procurement Procedures[25]

Procedure	Scope	Functioning	Pros	Cons
Open procedure	Standard situations	Official advertisement • anyone interested can submit a tender	Large number of applications can be received	Selection process can be burdensome due to volume of applications
Restricted procedure	Standard situation, with the intention to minimise administrative burden	Official advertisement • selection among multiple respondents • selected can submit a tender	The public authority can pre-select the businesses that participate	Requires at least 5 applicants
Competitive dialogue procedure	Need for design or innovative solutions; Negotiations needed because of specific circumstances (e.g. risks, complexity or the legal and financial requirements) Technical specifications cannot be established with sufficient precision by the contracting authority	Official advertisement • selection among respondents • contracting authority enters a dialogue with selected respondents to develop one or more suitable solutions • selected can submit a tender	Suited for complex contracts where the public authority cannot define the technical specifications right from the start (i.e. large infrastructure contracts)	Longer duration Requires at least 3 applicants
Competitive procedure with negotiation	(as above)	Official advertisement • selection among respondents • selected can submit a tender • contracting authority may reopen negotiation with tenderers to seek improved offers	The public authority can tailor the contract according to its specific needs by negotiating the terms of the contract	Can be used only in a limited number of cases (i.e. supplies intended exclusively for research or testing) Requires at least 3 applicants
Innovation partnership	Development of an innovative product, service, or work	Official advertisement • selection among respondents • contracting authority uses a negotiated approach to invite selected respondents to submit ideas to develop innovative works/supplies/services, • contracting authority may award partnerships to more than one supplier -> payment at intermediate targets, with the possibility to exclude one or more partners or to terminate the partnership	Allows for the combination of development and purchase elements tailored to public requirements	The process can only be used in limited circumstances (i.e. the goods, works and services that are sought are innovative)

[24] Directive 2014/24/EU on public procurement, Article 31

[25] See https://europa.eu/youreurope/business/selling-in-eu/public-contracts/rules-procedures/index_en.htm#shortcut-7-types-of-public-procurement-procedure

1.3.3 State aid compliance

State aid is provided by article 107 of TFEU[26] but can be grouped into four steps (see figure below).

Figure 1.10: State aid identification process

Source: t33 elaboration

For SII, these conditions can be further defined as follows:

1. Is the support granted by the State or through State resources?

EU resources managed directly or indirectly by the Union or by international institutions do not constitute State resources. For example, in the social sector, there is no State aid if an authority provides a contribution to a financial instrument through the EaSI programme (i.e. a contribution at Union level per article 38 1(a) CPR). The same applies to other Union measures such as EFSI and the SME initiative.

2. Is the recipient an 'undertaking'?

For SII, financial instruments can be targeted at financially excluded final recipients for activities related to job creation, social inclusion, education and social entrepreneurship. This implies a support to organisations (e.g. social enterprises) or individuals.

Direct support to individuals is in principle not State aid, if all support flows directly to individuals and is not retained by the provider. But when support goes to individuals in employment to achieve qualifications, there may be State aid implications if their employers indirectly receive support for training costs.

Social enterprises and non-profit organisations can all be undertakings if they place goods or services on a competitive market (which is often the case), so State aid rules apply to them.

3. Does the support confer an advantage to one or more undertakings over others?

The 'advantage' must be selective, favouring certain undertakings or the provision of certain goods/services. To assess this, the financial situation of an undertaking after support should be compared with its financial situation if there were no support. When support is on market terms – for example, through an open tender process – there is no advantage, and therefore no State aid.

4. Does the assistance distort competition, and does it affect trade between Member States?

[26] Aid granted by the State: '*...any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.*'

The 'potential to distort competition' does not need to be significant. It may include relatively small amounts of financial support to firms with a limited market share, so this may easily apply to the social economy. Any effect on trade is also treated broadly and covers any product or service that is tradable between Member States, even if the recipient does not directly export to other EU countries.

It is therefore important to stress that SII can involve State aid, even if it is designed to benefit society.

In financial instruments, State aid can happen at the level of financial intermediaries, of co-investors, or of final recipients:

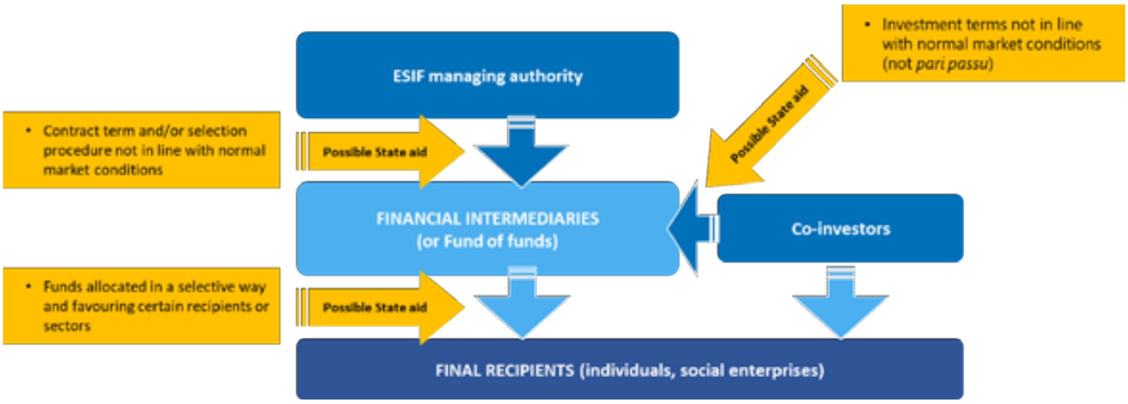
- There is State aid at the level of financial intermediaries (or fund of funds) if the contract terms or the selection procedure is not according to normal market conditions, i.e. for example if financial intermediaries are not selected on the basis of open, transparent, proportionate and non-discriminatory procedures, avoiding conflict of interest;

- There is State aid at the level of co-investors, if their investment does not respect normal market conditions, i.e. if they do not invest *pari passu with the managing authority;*

- *There is State aid at the level of final recipients if certain recipients (or certain sectors) are favoured by a selective allocation of the funds.*

The following figure illustrates the levels where State aid can happen in ESIF financial instruments:

Figure 1.11: State aid in financial instruments



Source: t33 elaboration

If at one or more levels of the financial instrument all four conditions listed at the beginning of this paragraph apply, then there might be State aid.[27] What then?

Firstly, if a support scheme is likely to include State aid it may still be realised, though the authorities will need to devote time and resources to ensuring it is compliant.

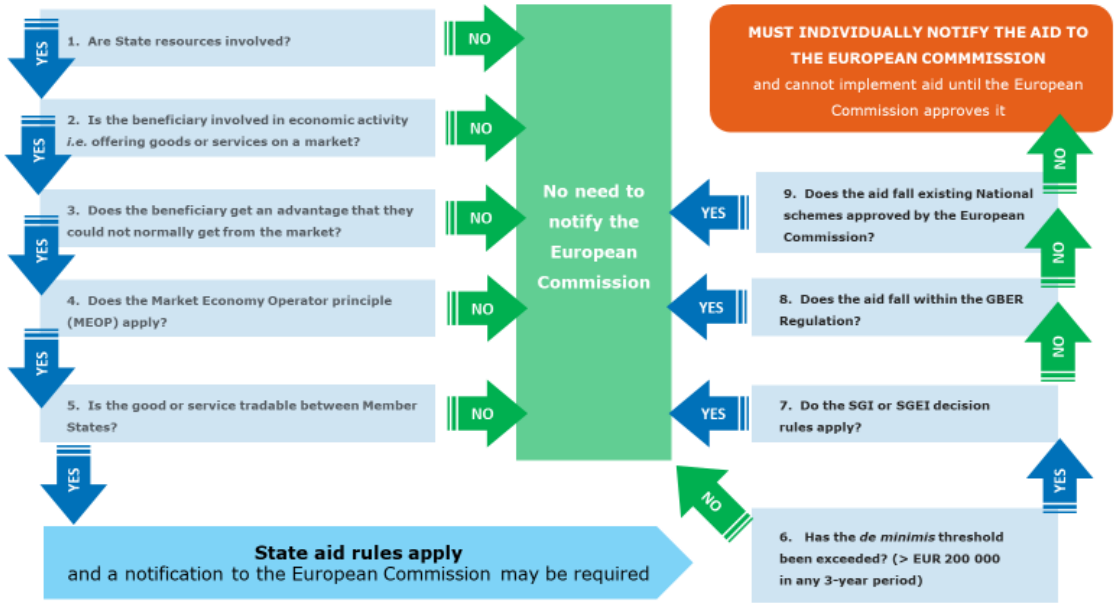
[27] For a focus on State aid in ESF financial instruments, see the fi-compass factsheet 'European Social Fund financial instruments and State aid', . https://www.fi-compass.eu/publication/factsheets/factsheet-european-social-fund-financial-instruments-and-state-aid

The regulations on financial instruments provide different routes to compliance:

- off-the-shelf instruments[28];
- *de minimis Regulation;*
- *General Block Exemption Regulation (GBER); and*
- *notification of the proposed financial instruments to the EC.*

The following figure summarises the procedure of detecting State aid and applying compliance.

Figure 1.12: Detecting State aid



Source: t33 elaboration

Although the GBER lists exempted categories that may be targeted by SII (e.g. 'aid for recruitment of disadvantaged workers and workers with disabilities', 'training aid', 'social aid for transport for residents of remote regions' and others[29]), social economy financing often falls under the *de minimis regulation. An overview of the regulation and its advantages is provided in the following box.*

Box 1.9: Detail

De minimis

The *de minimis* facility assumes that small amounts of support are unlikely to distort competition and trade in the European Economic Area and therefore do not represent State aid. The threshold is less than EUR 200 000 for any single undertaking over 3 rolling years. It is important to note that:

- The awarding body must check this ceiling is not breached;
- 'Years' refers to fiscal years of the undertaking;

[28] Currently, 5 of these instruments are available, see: https://www.fi-compass.eu/news/2016/07/new-shelf-financial-instruments-business-and-urban-development

[29] EU Regulation 651/2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty (GBER), article 1

- If an application would result in the threshold being exceeded, no de minimis support can be awarded, even if a partial award would not result in the ceiling being exceeded.

The advantages (+) and disadvantages (-) of de minimis aid can be summarised as follows:

+ Eligibility criteria are broad and applicable to several types of support;
+ Implementation under de minimis is fast as small amounts of support comply with State aid rules;
+ The support is not calculated as a share of project costs, but it must be less than the financial threshold.
- De minimis aid must be declared or be noted in a national database to track amounts received by all undertakings.
- The amount is limited and more so if a recipient has already had de minimis support. It is not suitable for large investments.

1.3.4 Combination of support

In the 2014-2020 EU regulatory framework financial instruments may be combined with other forms of support, such as grants or other financial instruments in the same programme, or from other EU programmes.

With SII interventions, combining support may raise the effectiveness of the support, and meet the social needs of a wider range of recipients.

Box 1.10: Detail

Non-financial services

In the social economy, alongside financial support, final recipients often require non-financial services. This includes final recipients who are disadvantaged people previously excluded from financial services or lacking experience. They may require professional assistance in the form of training or mentoring to make proper use of the financial support. In addition, there can also be an asymmetry between the requirements of social investors and the skills or capacity of the demand side actors.

Non-financial services can increase the effectiveness of SII financial instruments and can be delivered either by the financial intermediaries or by specialised third-party entities. Non-financial services can take a wide variety of forms and are often provided at no cost for final recipients, while some providers could request a fee to cover the costs. Common examples of non-financial services include tutoring and coaching programmes, business plan support, legal counselling, templates and e-learning platforms.

In the regulatory framework, two types of combination are allowed:

a) Combination of support within a financial instrument operation (a single operation), where the financial instrument and other forms of support (including technical support, interest rate subsidies and guarantee fee subsidies) are part of the same operation. The fund manager or, in specific cases, the managing authority provide the 'other forms of support', and such support is not directly paid to the final recipients.

b) Combination of support at the level of the final recipient (combination of two separate operations), where the financial instrument is combined with support from another ESI Fund priority or programme, or another EU financed instrument at the level of final recipient, e.g. in the form of a grant, technical support (non-financial services, see below), or other. In this case, the 'other form of support' is not part of the financial instrument.

Among EU programmes, EaSI (Microfinance and Social Entrepreneurship) and Erasmus+ (Master Loan Guarantee Facility) offer microfinance products that can address SII target groups, and therefore may be combined with support from financial instruments.

Box 1.11: Example

The Social Impact Investing Fund in Sardinia (Italy)

The Sardinia Social Impact Investing Fund combines innovation with some more risky factors. It is a public-private partnership which measures social impact and pays by results.

The fund goes beyond the classical logic of grant-based financing in the social sector and aims to attract co-investors looking for 'traditional' financial value, but also looking to reach social goals.

An initial analysis of social sector market failures carried out by the Region estimated a funding gap of some EUR 70 million, that should be covered by the fund.

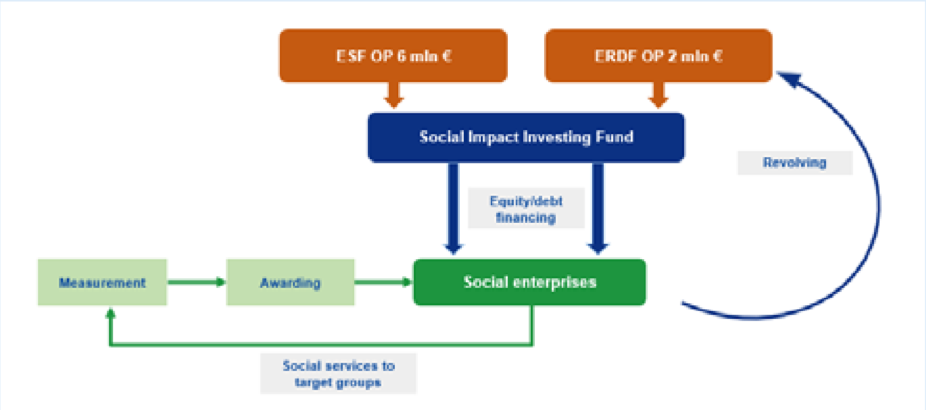
Thematic focus and target groups: the fund will finance actions in the social sector, especially those covering:

- integration and inclusion of workers that have dropped out of productive sectors (aluminium, chemicals, textiles, etc.), or that risk dropping out;
- professional /vocational training for people aged 15 to 20, who have difficulty finding a job;
- urban renovation;
- active inclusion of convicts and former convicts to reduce recidivism, through training, orientation, requalification and family support, strengthening professional skills and improving their employability;
- interventions in sectors such as the environment and cultural heritage.

Funding source and financial size: EUR 8 million ESIF – EUR 2 million from the ERDF Sardinia OP and EUR 6 million from the ESF Sardinia OP.

Both equity and debt investments offer rewards linked to results.

Functioning: the fund finances social enterprises through debt or equity. The enterprises provide social services and reaching pre-set social goals then generates payment.



Evaluation and measurement are central to the financial instrument. This includes selecting suitable projects (ex-ante), monitoring project performance (on-going) and the final measurement of outputs, results and impact (ex-post) following the logic of 'Payment by Result':

1.4
Measurement

Given the multiple social ramifications, the impact sought by social investors is often difficult to objectively capture and quantify. Private market goods and services have a purchase price, but the consumer does not pay for social impact goods, so their value has to be estimated through an unbiased assessment.

Social needs can be extremely complex and diverse, and in many instances estimating them is purely subjective and not possible to quantify. Examples include global poverty, quality of life, education and skills, human rights, cohesion of communities, mental health, cultural integration, democracy, reintegration into the labour market, level of happiness and gender equality.

However, these needs are real and very important in the lives of individuals and communities. Experts and organisations have developed many methodologies and tools to measure the durable impact of social initiatives. Over the last 20 years there has been a dramatic increase in the number of tools measuring social issues and the impact of social-oriented programmes, but with little or no connection between the different approaches.

Moreover, measuring impact makes sense only under certain circumstances, when an organisation operates at an ecosystem level, yet can exercise sufficient control over results to attribute impacts to its work. In that sense foundations, governmental departments, and international aid agencies are far better positioned than most non-profit organisations to measure impacts.[30]

Measuring social impact is a challenge, especially with the targeted beneficiaries who can be both socially and financially excluded. As a result, the core of most frameworks and tools to measure social impact is a comprehensive understanding of the people and communities that receive the support.

1.4.1 Who measures and when?

Literature and experience reveal a long list of social market operators with a direct interest in social impact assessment. Evaluators include governments, policy makers, NGOs, sectoral agencies, international organisations, institutional and private investors, non-profit entities, social enterprises, financial intermediaries, law firms and researchers.

As data become more readily available, social impact assessment is expected to evolve rapidly and solidify its importance in the social finance framework. Once an organisation has decided the indicators to be measured, they need to start collecting data systematically.

Measurement is already an essential part of the social impact approach, from before the intervention starts until after it ends. In most cases, the measurement and analysis of social indicators lasts beyond the intervention.

- **Before** – data sources already in the public domain are used to identify the social problems, determine the need for public intervention and its scale.

[30] Ebrahim and Rangan (2010), The Limits of Nonprofit Impact: A Contingency Framework for Measuring Social Performance

- **During** – data is constantly analysed in the design phase, to structure the services in accordance with the market requirements. Subsequently, data is used during implementation to manage projects effectively, make adjustments to maintain focus and respond to external factors and macroeconomic trends.

- **After** – data are measured after the end of a project to evaluate effectiveness and added value, also to determine remuneration (in case of payment by results schemes).

Impact measurement is important for organisations with a social purpose because it helps them demonstrate their impact on social problems. In addition, the data can refine and improve the programmes and fine-tune decision-making. Financers need the impact assessment primarily for reassurance that their money is well-spent and for examples to enable further fundraising. Factors to be considered when assessing social impact are described in the box below.

Box 1.12: Detail

Assessing impact of the intervention

Evaluating the impact of an intervention can be especially interesting if it is a financial instrument that was introduced for the first time.

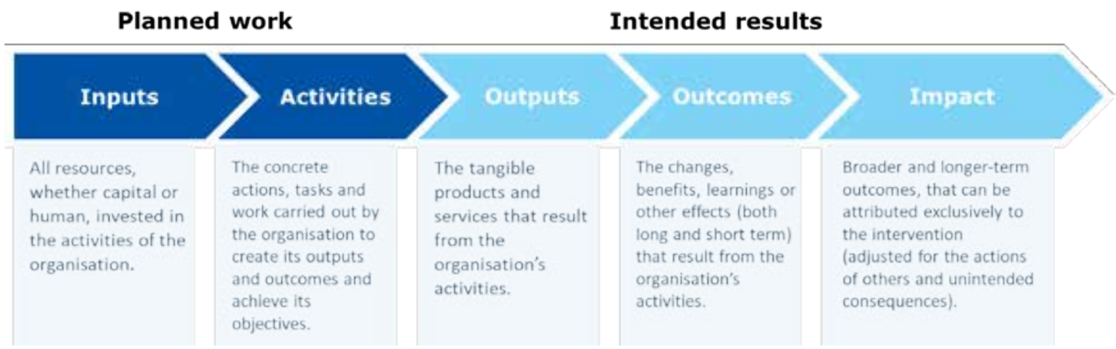
- Was there added value?
- Did it expand the range of financing available?
- Did the intervention encourage other investors to add liquidity?
- Were the targets achieved, and the needs addressed?
- Did the intervention crowd out other actors/instruments?

The timeframe for evaluation is important, as some of the changes can only be captured over the long run, including when cultural and mentality shifts are needed beyond skill building and matchmaking.

1.4.2 The impact value chain and indicators

The impact value chain has become a popular starting point for defining social impact as it clearly sets out the differences between inputs, outputs, outcome and social impacts.

Figure 1.13: Impact value chain



Source: t33 elaboration from EVPA, Measuring and managing impact - A practical guide (2015)

According to a survey conducted by the European Venture Philanthropists Association (EVPA)[31] on social investment in Europe most measurement focuses on outputs such as 'number of people reached' and less on outcomes and impacts. In addition, impact measurement is not yet fully integrated into the decision-making process (most respondents do not take social performance into account before releasing new funds).

Indicators are measurable evidence of meeting a goal and can be expressed as numbers, a ranking of systems or as changes in the level of user approval. **Quantitative indicators express information in numerical form, while qualitative indicators are based on individual perceptions (for example, responses to interview questions). The standard components of indicators are shown in the table below.**

Table 1.5: Indicators

Population	Who or what is changing?
Target	How many are expected to succeed?
Threshold	How much is good enough?
Timeline	By when does this outcome need to happen?

1.4.3 What tools are available?

Social impact measurement started to develop in the 1990s and there are now probably more than 150 methods[32]. However, there is no one-size-fits-all methodology.

Social impact assessment approaches include frameworks, such as the Social Return on Investment (SROI) and the UN Principles for Responsible Investing, which offer investors and businesses ways of measuring and conceptualising good practices. These and other methods are tools and platforms for businesses to track, report and quantify their impact[33].

Interventions using EU funds must follow guidelines provided by the EC, however monitoring and evaluation practices follow programme rules. Monitoring and evaluation at project level are still not standardised, but useful guidance includes:

1. Guidance for monitoring and evaluation of European cohesion policy – ESF.
2. Proposed approaches to social impact measurement in EC legislation and in practice relating to: EuSEF, EaSI, the EC Expert Group on Social Economy and Social Enterprises.
3. Impact measurement guidelines developed by The Social Impact Investment Taskforce.
4. A practical guide to measuring and managing impact, developed by EVPA.[34]

[31] EVPA survey (2013), European Venture Philanthropy and Social Investment 2011/2012.

[32] Foundation Center, 2015

[33] Commonly used methodologies and examples based on the theory of change and the impact value chain can be found in Clark et al. (2004) the Social Impact Investment Taskforce (2014) and the EC and OECD (2015) review .

[34] https://evpa.eu.com/knowledge-centre/publications/measuring-and-managing-impact-a-practical-guide

Many private investors use proprietary methodologies to determine social and environmental performance, if they measure impact at all. It is important for market operators to sustain their claim that they contribute to social and environmental goals, by measuring this contribution and presenting facts and figures. Olsen and Galimidi[35] analysed 25 methods and divided them into three groups:

- **Rating systems** – In terms of a fixed set of indicators, the impact investment's quality, or potential quality, is summarised by a score or a symbol.
- **Assessment systems** – A fixed or customised set of indictors evaluates characteristics, practices, and/or results of portfolio investments at a single point but does not provide explicit tools to manage the tracking of operational data by the organisation over time.
- **Management systems** – Provide tools for organisations to manage detailed operational information about drivers of impact.

Box 1.13: Detail

Catalogue of Approaches to Impact Measurement

1. B Ratings System
2. Balanced Scorecard modified to include impact
3. CHAT (Charity Analysis Tool)
4. Compass Assessment for Investors
5. Dalberg Approach
6. DOTS (Development Outcome Tracking System)
7. Ecological Footprint
8. EPRS (Environmental Performance Reporting System)
9. Fair Trade Certification
10. HIP (Human Impact + Profit) Framework
11. LEED (Leadership in Energy and Environmental Design) CERTIFICATION
12. MOVEMENT ABOVE THE US $1 A DAY THRESHOLD PROJECT
13. PDMS (Portfolio Data Management System)
14. PPI (Progress out of Poverty Index)
15. PROI (Political Return on Investment)
16. RISE (Real Indicators of Success in Employment) And Oasis (Ongoing Assessment of Social Impacts)
17. Social Impact Assessment
18. Social Rating
19. Social Value Metrics
20. SROI Analysis
21. SROI Calculator
22. SROI Framework
23. SROI Lite
24. SROI Toolkit
25. Trucost

Source: Olsen and Galimidi, Catalog of Approaches to Impact Measurement, 2008

[35] Olsen and Galimidi, Catalog of Approaches to Impact Measurement, 2008

Florman[36] divides approaches into **general** and **specific** (used by a single entity or focused on a single area). The authors based their analysis on a review of the various institutions' official websites and publications.

Table 1.6: Impact methodologies

General social impact assessment methodologies	• SROI • Social Rating • Social Impact Assessment • G4 Guidelines • Human Impact + Profit (HIP) Scorecard • Principles for Responsible Investment (PRI) • GIIRS / B Rating System • IRIS Metrics
Specific social impact assessment methodologies	• Social Value Metrics • Leadership in Energy and Environmental Design (LEED) Certification • Balanced Scorecard • Trucost • Accelerator / Compass Investment Sustainability Assessment • Dalberg Approach • Ecological Footprint • Progress Out of Poverty Index (PPI) • Development Outcome Tracking System (DOTS) • Environmental Performance Reporting System (EPRS) • Financial, Impact, Innovation and Risk Management (FIIRM) • Product Social Impact Assessment

The main features of SROI methodology are presented in the following box.

Box 1.14: Detail

SROI

One of the few standardised and widely accepted approaches in practice, SROI enables comparison of different projects that involve different stakeholders and seek different social impacts.

Published in 1997, the SROI was the first comprehensive quantitative method and uses monetary units to express social value added. It is an evaluation or monitoring tool and can be used for **strategic planning, communicating impact** and **attracting investment**.

A detailed guide on the use of SROI was developed by The SROI Network and is available at: http://www.socialvalueuk.org/

1.4.4 How to evaluate the net results?

Evaluation examines the implementation and impact of activities; the extent **outputs and results can be attributed directly to those activities** and whether the anticipated effects and benefits have been

[36] Florman et al., A critical evaluation of social impact assessment methodologies and a call to measure economic and social impact holistically through the External Rate of Return platform, 2016

realised. To accurately calculate the net social impact achieved by an intervention, the outcomes should be adjusted for various factors (see the box below).

Box 1.15: Detail

Factors to evaluate impact

Drop-off

When, over time, the output effects and observed outcomes decrease (e.g. recipients' relapse, lose the job attained, revert to previous behaviour). The organisation's definition of its outcomes sets the scope for how long they are expected to last (the sustainability of observed effects).
Evaluating the true impact of an intervention should account for the drop-off effect in the observed period.

Displacement

How much the original situation was displaced, or outcomes displaced other potential positive outcomes.
Displacement occurs when positive outcomes for beneficiaries accessing the organisation's services are offset by negative outcomes for another group (as a result of the intervention's activities).

Deadweight

The change that would have happened anyway i.e. the outcomes beneficiaries should experience if the organisation were not active. This is sometimes called the 'baseline' or 'counterfactual'. Deadweight includes the progress or regress beneficiaries typically make without the organisation's intervention.

Attribution

How much of the change results from the organisation's activities, and how much results from actions taken simultaneously by others (e.g. other SPOs, governments, etc.).

Unintended consequences

Can be positive or negative.

The main challenges of accurately evaluating the net results are access to independent statistics and the ability to define control groups to assess displacement, deadweight, drop off and attribution (which is not always feasible).

Two broad categories of impact evaluations are widely recognised by DG EMPL:[37]

- **Theory-based evaluation** (which follows each step of the intervention logic identifying change mechanisms, answering why and how an intervention works) – This approach mainly produces a qualitative estimate of impacts.

- **Counterfactual impact evaluation** (which uses control or comparison groups).

[37] DG EMPL, Monitoring and Evaluation of European Cohesion Policy, Guidance document, 2018

Counterfactual and theory-based impact evaluations should complement each other. Experience shows that many types of support from the previous programming period continue with a new programme. Therefore, the Commission encourages managing authorities to consider including impact evaluation data from previous programming periods where possible.

Some Member States carried out impact evaluations during the programming period 2007-2013. DG EMPL organised events where Member States shared their motivation for conducting such evaluations and the methodologies used. This showed that managing authorities have considerable experience in using such methodologies for different types of ESF interventions and target groups.

At the same time, experience has shown that impact evaluations entail significant challenges, notably with data availability, public administration and evaluation community capacity, as well as cooperation among authorities holding data. To support Member States in their efforts, DG EMPL has produced a practical guidance document for managing authorities to carry out counterfactual impact evaluations. This gives practical recommendations on when and how to carry out such evaluations and suggests practical ways to overcome difficulties such as data availability.

DG EMPL strongly encourages Member States to build on existing experience with such evaluations and further develop capacity.

Box 1.16: Examples

SIB for occupational well-being (Finland) – Impact indicators

This project aims to find an innovative way of **improving the well-being of public sector employees.** The economic loss from sick leave in Finland is estimated at around EUR 7 billion each year. In this context, Epiqus Occupational Wellness I (the SIB) has been implemented as a limited partnership fund to provide occupational wellness programmes for Finnish public sector employees over a 3-year period.

The impact is expected to result in **less sick leave** for public sector employees. If the goal of 2.1 less sick days per year per employee is met, the public sector would achieve significant savings, from which SIB investors would be repaid. On top of the measurable results, the SIB should bring material improvements in occupational and workplace well-being of the recipients, leading to a better quality of life and more effective functioning of public bodies.

SIB Augsburg (Germany) – Evaluation

Two evaluations were carried out as part of the SIB in Augsburg. A **success evaluation** to review and approve objectives for the SIB was commissioned to an independent third-party evaluator – a Munich-based law firm. Such an evaluation is crucial for every SIB project, since public sector funds are only used if the objectives are achieved.

In addition, a **scientific (process) evaluation** was conducted by the University of Hamburg to review implementation of the SIB and identify key factors to structure pay-for-success concepts. This evaluation provides important findings on the project execution but has no influence on the achievement of objectives. The evaluation results will be used to help develop other SIB projects.

02
Social Impact Bonds (SIBs)

02 Social Impact Bonds (SIBs)

2.1 Key features

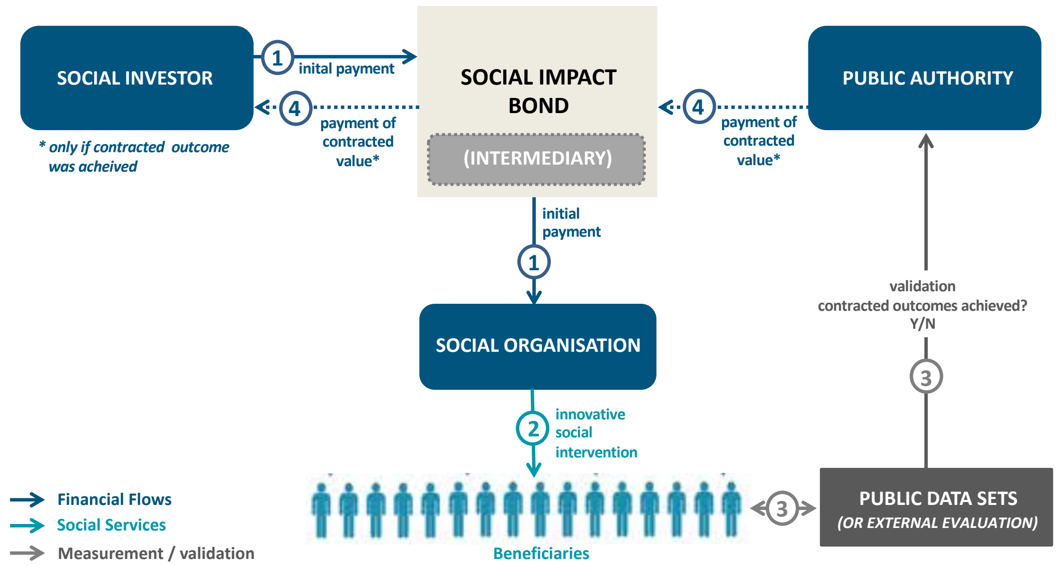
- A Social Impact Bond (SIB) is a type of Payment-by-Results contract involving 3 parties:
- a Public Sector Organisation (the 'Commissioner');
- a Social Organisation (the 'Implementing Entity' or 'Service Provider');
- a Social Investor.

The contract defines one or more results (social outcomes) to be attained in a specific timespan. In order to achieve these social outcomes:

- the social investor agrees to make the initial investment, providing the service provider the necessary working capital for implementing an innovative social intervention;
- the service provider (a social enterprise or other social organisation) agrees to use the investor's money for executing that intervention, directly addressing the social outcomes;
- the public sector commissioner (usually the public sector body directly responsible for the related public policy area) agrees to pay the social investor a specific amount for the contracted social outcomes if (and only if) they have been achieved in the required timespan.

The measurement and validation of the contracted outcomes is the trigger for payments from the public sector commissioner to included in the initial SIB contract. These measurement and validation activities can later be performed *ad-hoc* by external independent evaluators (e.g. universities) or can be supported by official data available to all contracting parties.

Figure 2.1: SIB functioning scheme



Implementing a SIB may also involve intermediaries (consultants, service providers) during different stages of the process to overcome high initial transaction costs. Intermediaries usually provide technical assistance, bring investors together, perform due diligence, negotiate and develop contracts, etc. In the early stages of SIB take-up, intermediaries may even be responsible for end-to-end management, throughout the bond's implementation.

** Adapted from EC/EIB FI Compass ESF, 'The Portuguese Social Innovation Initiative – The Social Impact Bonds Programme – Using ESF to finance Social Innovation and Social Entrepreneurship', 2018 (https://www.fi-compass.eu/publication/factsheets/factsheet-fi-compass-study-social-impacts-bond-programme-under-portugals)*

2.2
Market Assessment

2.2.1 Analysing needs (targets and market failures)

Not all social interventions can be financed through SIBs, but these are appropriate financing mechanisms for social interventions which:

- have a specific objective, one or more easily identifiable target groups and a clear intervention model.
- aim to achieve uncertain but quantifiable results (social outcomes), that can easily be measured / validated.
- complement present public policies, either:
  - by targeting social problems not fully addressed by existing public interventions;
  - or, if addressed, by using innovative approaches to deliver better and/or more effective results than existing public interventions.

With a strong focus on prevention, SIBs may target social problems in a broad range of domains (see the box below).

Box 2.1: Detail

Social Problems

non-exhaustive

Climate Change, Environment, Health, Social Protection, Justice, Democracy, Migration, Discrimination, Education, Employment, Ageing, Energy, Agriculture, Housing, Inclusion

Up to 2016, 60 national, regional or local SIBs were launched in 15 countries, raising more than USD 200 million from investors to address social challenges[38]. Since then, the number and scope of SIBs has been steadily growing and they are increasingly aligned with the UN SDG Framework.

[38] OECD/LEED, 'Understanding Social Impact Bonds', 2016 (http://www.oecd.org/cfe/leed/UnderstandingSIBsLux-WorkingPaper.pdf) and Social Finance, 2016 (http://gsgii.org/wp-content/uploads/2017/06/SIBs-Early-Years_Social-Finance_2016_Final3.pdf)

Figure 2.2: Sustainable Development Goals 2030

Source: United Nations, 2015 (Resolution 70/1 of the United Nations General Assembly – Sustainable Development Goals 2030)

The exponential growth of SIBs worldwide (and particularly in Europe) is a consequence of:

1. *Growing unmet demand*

   Over the past 20 years, the world has experienced more emerging, cross-cutting and often systemic ('wicked-problem') societal challenges not easily addressed by current mainstream approaches and public policies - e.g. climate change, ageing, migration, structural unemployment, etc.

2. *Market failures - Public Sector*

   Following the recent financial and sovereign debt crisis, increasing demand for public sector responses and services has coincided with growing budget constraints at all levels of government. This shortage of funding adds to traditional barriers hindering public sector innovation, namely short-term planning and budget horizons, limited scope for experimentation and testing, and, consequently, high levels of risk aversion.

3. *Market failures - Social Organisations*

   Most social organisations experience difficulties in accessing stable, long-term funding sources adjusted to their needs[39] and survive on fragmented donations from philanthropists or public contracts providing mainstream social responses. These offer limited scope for process or service innovation.

[39] According to DG Internal Market, Industry, Entrepreneurship and SMEs, *'Social enterprises are struggling to find the right funding opportunities due to the lack of understanding of their functioning and their small size' (https://ec.europa.eu/growth/sectors/social-economy_en).*

4. *Market failures - social investors*

There are three main issues preventing traditional investors from financing innovative social interventions under a SIB:

- Risk: high perceived risk and no collateral;
- Return: high trans action costs for expected below-market returns;
- Impact: positive externalities not recognised or taken into account.

Moreover, the present fragmentation and short-term drive of philanthropic initiatives in most countries reduce the options for financing innovative social interventions. Although growing, impact investing and payment-by-results schemes are still an emerging reality.

2.2.2 Potential demand (financial gap)

SIBs are little used in most Member States, so there is still not enough data for a good quantitative estimate of the financial gaps associated with unmet potential demand and the abovementioned market failures. In this context, qualitative and benchmarking analysis may be useful.

However, calculating potential demand also depends on individual Member States which have different governance structures, accountability and decentralisation. So, the same SIB might be commissioned by a central government agency in one country or by a regional body or even a municipality in others, depending on who is responsible for the targeted public policy. To be successful, an SIB must be launched by the public sector body with direct responsibility (and budget) for the specific public policy domain addressed by that particular SIB.

Moreover, from a strictly financial perspective, different regulatory frameworks, as well as different approaches to risk and return may also lead to significant variations in SIB financing structure and design.

The box below identifies questions to be answered in the 1st step when setting up an SIB (or SIB Programme). The answers will ultimately define the scope and design of the SIB.

Box 2.2: Checklist

1. Deciding on the theme

- What is the top societal challenge or priority for the country/region/municipality?
- Can it be addressed by a SIB?
- What would be an effective outcome directly related to that challenge or priority?
- What indicator/metric could be used to measure that outcome?
- Is there recurring data / statistics to support that measurement process?

2. Identifying the SIB stakeholders

PUBLIC SECTOR

- Which public sector entity is responsible for that public policy domain and/or budget?

- Does that entity value SIBs as a way to complement current public policies and/or as a test-bed for innovative approaches?

SOCIAL ORGANISATIONS

- Which traditional social organisations and social start-ups are active in this domain?
- Which of these are implementing innovative interventions?

SOCIAL INVESTORS

- Who would be interested in investing upfront in a SIB?
- Under what conditions?

3. Are European Structural and Investment Funds (ESIF) available for a SIB?

2.2.3 Understanding the value added of SIBs in relation to existing policy tools

When compared to existing policy tools, SIBs are a more effective mechanism to promote innovation in public policies, by aligning incentives for all stakeholders:

- For the public sector, SIBs are a controlled platform to test new services and to validate new long-term approaches, producing inputs to update current public policies. SIBs are an effective complement to traditional 'end-of-line' public policies, requiring no upfront payment while transferring financial risk from public sector authorities to social investors – if the results (social outcomes) are not achieved, the public sector doesn't repay the investors.

- For social organisations, SIBs are a way to access stable, long-term financing for innovative interventions. By focusing on outcomes rather than processes or pre-set input/output models, SIBs enable social organisations to better address individual needs, as well as to dynamically adjust interventions to performance information and/or changes in the delivery environment.

- For social investors, SIBs are a virtuous alternative to traditional financial investments, blending financial returns with social impact. SIBs might also work as a revolving mechanism: if the social outcomes are achieved, the investors get their money back (potentially with a risk premium) and can recycle or reinvest it in new SIBs.

SIBs are effective in attracting additional private capital for projects dealing with societal challenges, diversifying funding sources and allowing stakeholders to achieve more impact within existing budgets. As an outcome payment scheme, SIBs also contribute to improving project quality, with implementation supported by rigorous impact measurement processes, quantitative metrics and verifiable outcomes.

2.3
Delivery and Management

2.3.1 Design options

SIBs can have different structures depending not only on the specific context and objectives, but also on the regulatory framework. As a result, there are currently several variations to the standard SIB model presented in section 1, mostly in terms of:

- Outcome setting *(i.e. single outcome vs. multiple outcomes with fund recycling)*;
- Governance and contractual arrangements *(cf. section 3.4)*;
- Financing structure *(i.e. combinations of risk/return between more philanthropic and more market-oriented investors)*.

One of the most frequent design options, usually adopted to attain critical mass and reduce SIB transaction costs, is aggregation – i.e. evolving from a SIB-by-SIB approach to SIB programmes and/or SIB-related funds.

Developing an aggregated SIB programme or fund also facilitates a second structural design option for SIB deployment – the use of ESI Funds for SIB financing.

In setting-up SIBs, ESIF can be used to finance[40]:

1. *Technical Assistance*

   ESIF could be used as non-reimbursable support (grants) to finance initial capacity-building and awareness efforts, targeting potential SIB stakeholders (public sector authorities, social investors, social organisations and intermediaries). These initial grants could also be used to finance preparatory work for SIB set-up, reducing transaction costs and barriers to take-up.

   Later in the process, ESIF grants could also finance additional technical work throughout the SIB life cycle, namely activities related to outcome measurement and validation (e.g. development of unit cost databases, outcome validation by independent experts, etc.).

AND

2. *Pre-financing Funds (investing in SIBs, providing initial capital)*

   ESIF could be used as a pre-financing financial instrument co-investing directly in SIBs alongside social investors or in combination with other non-ESIF financial instruments such as the European Fund

[40] A more detailed analysis on the use of ESIF for SIBs can be found at *EC/EIB FI Compass ESF, 'The Portuguese Social Innovation Initiative – The Social Impact Bonds Programme – Using ESF to finance Social Innovation and Social Entrepreneurship', 2018 (https://www.fi-compass.eu/publication/factsheets/factsheet-fi-compass-study-social-impacts-bond-programme-under-portugals).*

for Strategic Investment, European Investment Fund Payment by Results (EFSI/EIF PbR) Platform, lowering the perceived risk of outcome contracting and attracting social investors and capital.

Although less aligned with the underlying SIB model, other types of ESIF financial instruments using debt (e.g. providing loans to social investors for SIB investments) and guarantees (e.g. protecting *part* of the capital invested in each SIB from non-payment) might also be considered. However, in both cases, strict additional provisions need to be established to avoid excessive risk transfer from investors.

OR

3. *Outcome Funds (paying for validated SIB outcomes)*

   ESIF could be used, in the form of "delayed grants"[41], to pay for each SIB validated outcome(s). Following outcome validation, each payment would be made under a pre-contracted lump sum value, set per validated outcome.

   To achieve critical mass, this mechanism should ideally be structured as an Outcome Fund, combining ESI Funds with central, federal, regional and/or local government budget.

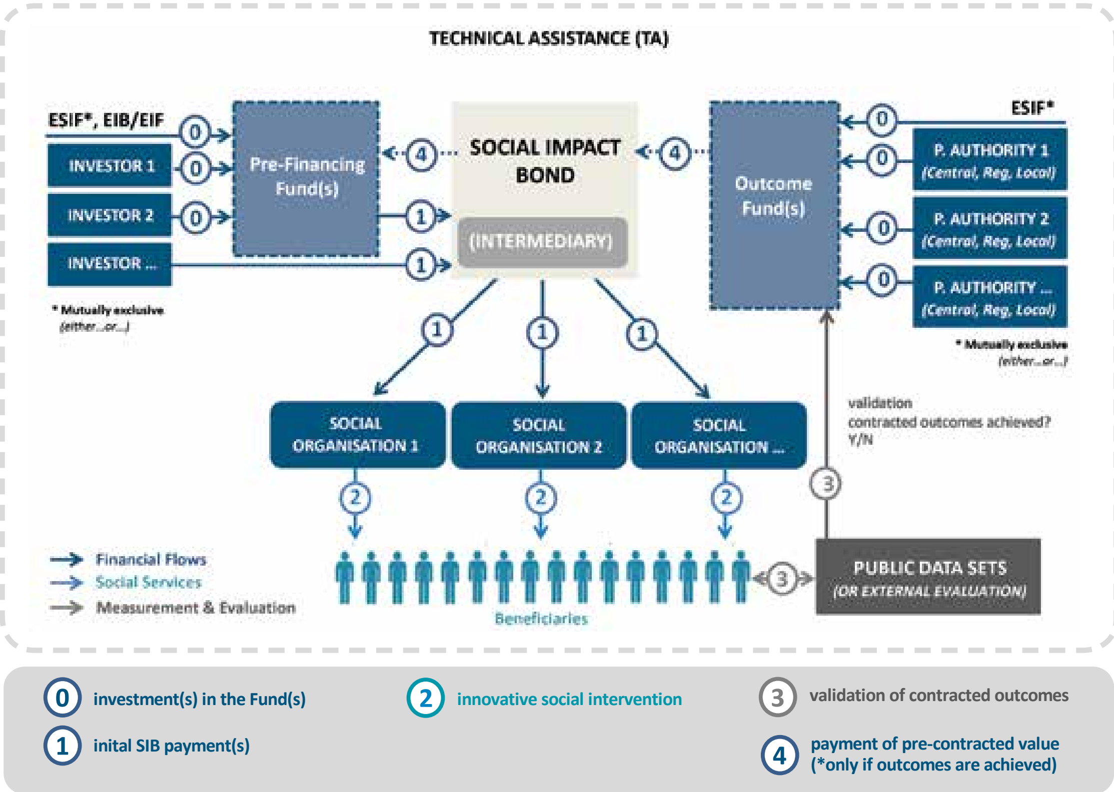
Combination options:

- If totally segregated, SIBs ESIF TA grants (1) can be subjected to stand-alone applications. Alternatively, these TA grants can also be part of a single integrated SIB application, as specific activities and cost components.
- In contrast, ESIF support to pre-finance investments (2) and outcome payments (3) should be mutually exclusive, to avoid double financing[42].

[41] ESIF non-reimbursable support (grant) contracted as part of the initial SIB set-up, with no advance payment and payment made only at a later stage if (and only if) each outcome is achieved.

[42] The only potential exception being guarantees, only triggered and paid to investors if outcomes are not validated and consequently if lump sum payments for outcomes don't take place.

Figure 2.3: Technical assistance



To sum up, as a 2nd step to create an SIB (or SIB Programme), some initial key design decisions must be taken, which will shape the SIB model to be adopted (see box below).

Box 2.3: Checklist

0. Outcome and financing structure

- Should SIBs with multiple (parallel or sequential) outcomes be allowed or even promoted? Under what conditions?
- Should multiple social investor profiles be allowed? Philanthropic only? Market-driven only? Both? Should they be allowed to invest jointly with different levels of risk/return/impact? Under what conditions?

1. Level of aggregation

- A SIB-by-SIB approach?
- An integrated approach?
  Aggregating pre-financing investments? Aggregating outcome payments? Aggregating both?

2. Use of ESI Funds for SIB deployment

- Yes? No? Which fund – ESF, ERDF, a combination of both?
- For Technical Assistance? Early stage? Ongoing?
- Individual stand-alone applications? Or embedded in a global SIB application?
- Pre-financing (co-investment vs. debt vs. guarantee) or for outcome payments (central, regional or/and local; for generic or thematic SIBs payments)?

2.3.2 Key actors of the ecosystem

SIBs usually involve three main types of stakeholders, as noted above:

- Public sector organisations (the 'commissioner' or 'contracting entity')

  In an SIB, the commissioner is usually responsible for paying a pre-contracted value on validation of the outcomes. Payment occurs if (and only if) the outcomes are validated against targets in the initial SIB contract.

  These commissioners can be central, federal/regional or local authorities depending on the public sector administrative structure. In all cases, the contracting entity must be the public sector body directly responsible for the public policy targeted by that SIB. Usually, they are also the entity responsible for managing the relevant budget (or part of the budget).

- Social organisations (the 'implementing entity' or 'service provider')

  In an SIB, responsibility for implementing the social interventions that directly lead to the contracted outcomes lies with social organisations. These are solely responsible for all interactions with the SIB target groups (e.g. young unemployed, deprived children, elderly affected by a chronic health condition, people with disabilities, families at risk of poverty, etc.).

  Different types of social economy organisations (social enterprises, associations, cooperatives, NGOs, etc.) can be implementing entities in an SIB. Irrespective of their institutional profile, all must have a track-record of effective innovative social intervention in the specific domain targeted by that SIB.

- Social investors (the 'investor')

  In an SIB, social investors provide the initial investment (pre-financing) that allow social organisations to implement the intervention leading to outcomes. If (and only if) these outcomes are achieved will investors in an SIB receive their money back, usually with an additional risk premium.

  Social investors can be very diversified, with different risk/return/impact profiles, ranging from foundations and other philanthropic organisations, to enterprise corporate social responsibility (CSR) areas, to more market-driven entities, like financial institutions, pension funds, etc.

Two other types of stakeholder might also play a role in SIB deployment:

- Intermediaries.

  These are usually consultants or other service providers with expertise in social finance, impact investment or SIB contracting, who act as facilitators in the initial set-up of an SIB, reducing complexity and transaction costs for the main stakeholders. These intermediaries can be responsible for a wide range of activities, from providing technical assistance to fund-raising, from performing due diligence to supporting contract negotiation and development. In less mature contexts, they may even be responsible for the end-to-end management of a specific SIB or SIB portfolio.

  Finally, some intermediaries can take responsibility for managing Pre-Financing Funds, Outcome Funds or Guarantee Funds (to cover for SIB non-performance), provided they are mandated and allowed to operate as such (financial intermediaries).

- Independent Evaluators.

  An SIB contract should stipulate how outcomes will be measured and validated against the targets. In some SIBs, relying exclusively on public data sets might not be feasible, e.g. in specific and/or emerging areas where such data does not yet exist or does not have the required detail. In these situations, SIB contracting parties might pre-agree to call on independent external evaluators (universities, research companies, experts, etc.) to perform this task.

The box below lists key actors involved in setting up and maintaining an SIB (or SIB Programme) in the 3rd step.

Box 2.4: Checklist

1. Public Sector Organisations ('commissioners')
2. Social Organisations ('implementing entities')
3. Social Investors (the 'investors')

AND
4. Intermediaries ('SIBs specialists' and/or 'Financial Intermediaries')
5. Independent Evaluators

KEY QUESTION: Considering the national, regional and/or local context of an SIB or SIB programme, how to best build and promote a diversified SIB ecosystem, able to generate a stable SIB pipeline over time, by attracting capital and/or expertise from these types of stakeholder?

2.3.3 Additional resources and private/public co-investors

Contracting a SIB usually implies setting fixed values upfront for both initial investments and outcome payments. Therefore, although rights and positions may be exchanged or transferred to other entities if the SIB contract allows, there is usually no space for adding additional resources for a SIB after the initial contracting stage.

Conversely, additional financial resources can be added - at all times – when using[43]:

- Pre-financing Funds (to invest in SIBs);
- Outcome Funds (to pay for validated outcomes).

Resources for pre-financing funds are normally private, either philanthropic or more market-driven, whereas for outcome funds, the resources are public.

ESIF resources can also be added to these funds (but not to both simultaneously, to avoid double financing), to address market failures and financing gaps, attracting other stakeholders[44]. Additionally, the European Fund for Strategic Investments (EFSI), through the European Investment Bank (EIB) and European Investment Fund (EIF), has also made social impact investment instruments available which provide additional financial resources and which invest in SIB initial pre-financing stages[45].

[43] cf section 3.1. Design options

[44] Section 3.1. Design options

[45] http://www.eif.org/what_we_do/equity/efsi/call/Guidance_for_social_impact_investors.pdf

Moreover, when compared to traditional contracting based on inputs (cost of activities developed / resources spent) or outputs (cost of products or services made available), there are two revolving effects for SIBs that also contribute to providing financial resources to maintain an SIB programme:

- outcome payment money recovered by social investors when outcomes are validated can be recycled for reinvestment in new SIBs (or in later stages of the same SIB);
- public money not spent paying for outcomes (i.e. when particular outcomes are not achieved) can be used for new SIBs[46].

The box below summarises key questions when attracting additional financial resources to SIBs.

Box 2.5: Checklist

Level of investment allowed:

- Direct investment SIB-by-SIB? Investment in n SIB portfolio through a pre-financing fund? Should both levels of investment be allowed?
- Should public budgets be allocated SIB-by-SIB, according to specific priorities of each commissioner? Or should they be integrated in a larger pool - without any sort of earmarking - paying for each validated outcome of a broader SIB portfolio?

When using ESIF or EFSI:

- How should such resources be used in a way that promotes rather than crowds out social investors and/or public sector financial involvement in SIBs?
- What mechanisms can increase participation of both social investors and public sector commissioners? How should ESIF/EFSI resources be phased out as the ecosystem matures?

2.3.4 Governance and implementation arrangements

An SIB contract sets the rules to be applied for the full duration of that SIB. With the potential to motivate or hold back SIB deployment and future take-up, its provisions usually cover:

1. *SIB Governance*

   A SIB contract identifies the contracting parties and defines their roles, rights and responsibilities.

   This contract is usually established between the public sector commissioner and a consortium (or Special Purpose Vehicle - 'SPV') that includes the SIB investor(s), the social organisation(s) responsible for implementation of the intervention, and sometimes also the intermediaries supporting the operation. Normally, the contractual relations between members of the consortium are autonomous, with members establishing internal arrangements and assuring these are aligned with the SIB

[46] in compliance with each Member State public budget rules

contract. To reinforce this alignment, a Memorandum of Understanding or Consortium Agreement is often used to support this section of the contract, making it simpler.

There are also several variations to this standard governance model depending on SIB design, context and applicable law. Most of these variations have simpler contractual arrangements between just two parties, but then often require back-to-back contracts with the remaining stakeholders, increasing overall complexity and transaction costs. These include contracts directly established between the public sector commissioner and the implementing social organisation (requiring back-to-back contracts with the investor and eventually also with the intermediary), contracts directly established with an intermediary that is then responsible for all downstream contracts (with social investors and the implementing social organisation).

Independent external evaluators, whenever required, are usually directly contracted by public sector commissioners.

Finally, in contractual provisions, SIB pre-financing funds or any outcome funds take the role of social investors or public sector commissioners, respectively.

2. *SIB Intervention Model*

An SIB contract usually includes a description of the social intervention, focusing on:

- the social problem to be addressed;
- the approach to address that problem;
- target groups and their selection process (including the number of individuals to benefit);
- the expected impact of the SIB on these end-beneficiaries;
- other implementation arrangements and caveats.

An SIB intervention model should find the right balance between flexibility (allowing implementing entities to better adjust to specific individual needs of end beneficiaries, as well as to unexpected external shocks, for the duration of the SIB) and mandatory conditions (clearly identifying the requirements that must be fulfilled in all cases, e.g. legal requirements, established to avoid skimming strategies in selecting beneficiaries).

3. *SIB Outcome Measurement Model*

An SIB contract details the contracted outcomes, metrics to beu used, targets, calculation method and sources of evidence for its validation[47].

4. *SIB Financial Model*

An SIB contract pre-sets the value to be paid for achieving each social outcome. It also identifies the financial flows between contracting parties and maps the conditions under which they take place. In some cases, an SIB contract also includes a detailed budget description supporting or justifying the value to be paid for the outcome(s)[48].

[47] See section 4, for additional details on outcome measurement in an SIB.

[48] A detailed budget is usually part of the contract or a support document, when there are no cost metrics for particular outcomes at public sector level or the value for each outcome is proposed by the social investors and/or implementing entities.

This section of the contract also formalises the commitments from SIB social investors. These commitments might differ depending on the financing structure and chronogram of each SIB, for example:

- more impact-focused philanthropic investors might provide upfront donations or transfer a share of their outcome payments to subsidise returns for more market-driven investors;
- some SIBs might focus on a single long-term outcome contract with a single payment, while others might adopt multiple outcomes / multiple payment contracts, as a way to allow the recycling and reinvestment of each SIB's outcome payments into the same SIB, reducing the need for higher initial investments.

  Contracting multiple outcomes can reduce risk for both initial social investors and public sector commissioners:

  – public sector entities can achieve and communicate quick wins;

  – initial social investors avoid fully committing the total capital upfront, however they can recycle payments for outcomes into subsequent investments under the project.

For social organisations, SIB financial flows should be neutral – they receive capital to implement the intervention either from social investors (in a SIB approach) or from the public sector (in the case of more traditional public service contracting).

Finally, when using ESIF for SIB financing, additional implementation arrangements must also be considered[49]:

- when ESIF is an investor/co-investor or supports the provision of loans or guarantees to SIBs, financial instrument rules apply;
- when ESIF replaces (or partially replaces) the public sector as the SIB paying entity, the above-mentioned provisions 1 to 4 apply, becoming part of the acceptance agreement signed with beneficiaries of all approved ESIF applications.

  In this case, a mechanism for public sector engagement must still be maintained, namely for validation of each SIB's alignment with public policy priorities, the targets and/or values to be contracted and the outcomes or access to the data sets necessary for that validation.

The box below identifies the main items to be considered when drafting an SIB contract.

Box 2.6: Checklist

1. Governance

- Who are the contracting parties?
- What are their roles, rights and responsibilities?
- How do they interact?

[49] A more detailed analysis on the use of ESIF for SIB deployment can be found at *EC/EIB FI Compass ESF, 'The Portuguese Social Innovation Initiative – The Social Impact Bonds Programme – Using ESF to finance Social Innovation and Social Entrepreneurship', 2018 (https://www.fi-compass.eu/publication/factsheets/factsheet-fi-compass-study-social-impacts-bond-programme-under-portugals).*

2. Intervention model

- How is the social intervention being implemented?
- What social problem is addressed? What approach addresses that problem?
- Who are the target groups / beneficiaries? How are they selected? What is the expected impact of the SIB on these beneficiaries?

3. Outcome measurement model

- What are the outcome(s) to be contracted / What are the targets?
- What metrics should be used? What calculation method? And what source of evidence should be used for outcome validation?

4. Financial model

- What is to be paid for the outcome(s)?
- What are the financial flows between SIB contracting parties? And under what conditions will these flows take place?

Complexity and transaction costs on setting up SIBs substantially reduce over time, namely through standardisation and step learning effects. Aggregation strategies like establishing pre-financing and/or outcome funds also help to improve this aspect.

2.3.5 Procuring the SIB

In their standard form, SIBs are a contract involving a public sector commissioner, so public procurement rules apply.

However, although public procurement can already be used to pursue positive societal changes and promote innovation, there are currently no specific provisions that directly apply to innovative social contracting, namely to SIBs - or to any other type of social outcome contracting. As a result, even under the new (and more flexible) EU public procurement regulations, these contracts must fit into rules that are not well adjusted to their hybrid features.

Furthermore, important differences between Member States in the application of this common EU legislative framework still exist. In some Member States, contracts between the public sector and social organisations have specific rules.

Despite regulatory differences in Member States that might lead to different approaches to SIB contracting under the same public procurement regulation, the following EU general principles relating to public contracts apply in all cases; transparency, publicity, non-discrimination, equal treatment, mutual recognition and proportionality.

In a standard SIB, the public sector organisation is always the contracting entity and the operational risk of the contract is always transferred to investors. In some Member States this type of agreement is still defined as a 'service contract', while in others it is a 'concession contract'. Depending on its framing, slightly different procedures apply (e.g. for negotiation, awarding the contract, etc.)[50]. Where the related costs are accounted for in the financial statements of the contracting public authority is also relevant.

By any standard, SIBs fall under the procurement of innovative solutions category. Consequently, some features of the new EU public procurement regulatory framework, such as 'partnership for innovation' and 'competitive dialogue', may also apply to SIB contracting, providing additional flexibility for co-creation processes and reducing some of the mismatches.

When ESIF is used to pay for SIB outcomes (by means of a 'delayed grant'), ESIF regulatory framework rules apply. This is the most extreme scenario of compliance of a grant mechanism with the ESIF result-orientation principle. Consequently, public procurement principles and provisions are embedded in the process, from the launch of requests for ESIF applications, to selection processes, to the award of grants to approved applications.

Box 2.7: Detail

PUBLIC PROCUREMENT RULES APPLY TO SIBs:

- SIB contracting processes must be transparent, public, non-discriminatory, assure equal treatment, mutual recognition and proportionality.
- Standard SIBs may be defined as either 'service contracts' or 'concessions contracts'.
- When using ESIF to pay for the contracted outcomes, ESIF requests for proposals work as a SIB tendering process. Acceptance agreements must be adjusted to fully integrate SIB provisions.
- Although there are currently no specific provisions that directly apply to innovative social contracting (namely to SIBs), public procurement can already be used to pursue positive societal changes and to promote innovation.
- SIBs fit under the category of procurement of innovative solutions. Consequently, though not fully adjusted to SIBs, some Member States are already using flexible mechanisms offered by the new EU public procurement regulatory framework (such as 'innovation partnership' and 'competitive dialogue') for SIB contracting.

2.3.6 State aid compliance

As explained in the previous paragraph, the contractual agreement regulating a standard SIB is between a public sector authority and SIB social investors, who bear the financial risks.

If these investors are selected on the basis of an open, transparent, proportionate and non-discriminatory procedure, avoiding conflict of interest, this excludes any risk of State aid.

The basic checklist to determine any need for an in-depth analysis on State aid is:

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[50] Respectively Directive 2014/24/EU on public procurement and Directive 2014/23/EU on the award of concession contracts

1. Is the support granted by the State or through State resources?
2. Is the recipient an 'undertaking'?
3. Does the support confer an advantage to any undertakings over others?
4. Does the assistance distort competition, and does it affect trade between Member States?

A SIB can involve State aid if social enterprises in a SIB are undertakings in the sense of Article 107 of the TFEU and could receive an advantage they would not obtain under normal market conditions.

If the answer to all above listed questions is 'yes', then to avoid State aid infraction the SIB should:

- Respect the *de minimis* Regulation;
- Fall under the General Block Exemption Regulation (GBER);
- Be an off-the-shelf financial instrument (which seems unlikely for an SIB);
- Be notified to the EC.

For more detail, State aid compliance options have been analysed in chapter 1.3.3.

2.4
Measurement

2.4.1 Definition of expected results

When contracting a SIB, setting the social outcomes to be achieved implies defining upfront the:

- indicator for measuring the outcome (e.g. beneficiaries employed);
- quantified target (e.g. 5 000 individuals or 75% of beneficiaries);
- deadline for meeting the target (e.g. 12 months after concluding the intervention);
- sources of evidence (and/or the measurement method), which will validate if the target was met by the deadline.

Contracting a SIB with multiple outcomes requires setting targets and deadlines for each outcome (usually these are measured against the same indicator, using the same sources of evidence and/or measurement method). There are numerous options for defining multiple outcomes - the most common being setting parallel (e.g. cohorts) or sequential outcomes (e.g. consecutive improvements) or a mix of both, depending on context, type and area of intervention.

Public sector entities are responsible for the public policies targeted by SIBs, so they are the key stakeholder for the definition of the results to be achieved and should always be fully involved in the initial stage of SIB set-up.

Also regarding sources of evidence, whenever public sector administrative data is available, it should be used as the main source for the validation of outcomes, as it makes the deployment of SIBs faster and cheaper. In fact, public sector entities in all Member States already possess very detailed and up to date data related to the public systems and policies (e.g. health, education, social security, etc.) that tend to be targeted by SIBs or other outcome contracting mechanisms. At an international level there are also cross-border data sets (e.g. OECD, EUROSTAT) that, in more straightforward cases, could be used to improve comparability and standardisation of SIBs, increasing the potential for scale and replication of projects. Additionally, when using ESIF financing for SIB deployment, ESIF result indicators could also be considered, whenever possible, for contracting outcome payments. This could mean using the same indicators for triggering SIB outcome payments and for ESIF reporting to the managing authorities of operational programmes, reducing additional reporting needs.

Setting expected outcomes in a SIB contract is also directly linked to defining the value to pay for these outcomes when they are achieved. This must involve the public sector entities responsible for the public policy targeted by that particular SIB. For each SIB, there is usually a choice in setting an outcome value that maximizes cost savings for the public sector with the social impact and positive externalities of that SIB - the latter option being considered by an increasing number of implemented SIBs. Some Member States with more experience of outcome contracting are already aggregating public data into validated unit cost databases and starting to use *rate cards*[51] to price and bid directly for social outcomes, speeding up standardisation and initial contracting processes.

Finally, in a SIB initial contracting stage, as important as setting the outcomes and the value to be paid for these, is defining the consequences of the impact measurement process, as well as its enforcement mechanisms.

All details must be clear and pre-agreed among all contracting parties, remaining stable until the end of the contract (see box below).

Box 2.8: Checklist

DEFINING THE OUTCOME:

- What is the right indicator to measure the expected outcome?
- Taking into account the current situation, what should be the target?
- In what timeframe?

IDENTIFYING SOURCES OF EVIDENCE:

- What sources of evidence should be used to measure achievements?
- National, regional, local administrative data?
- International data (EUROSTAT, OECD, etc)?

SETTING THE VALUE TO PAY FOR THE OUTCOME:

- Should the payment be more cost efficient or impact driven?
- Are unit cost databases in place? Can/should rate cards be used to simplify the SIB bidding process?
- What are the conditions for outcome payment / non-payment? And what enforcement mechanisms should be put in place?

2.4.2 Measurement of social results

The following questions must be answered when designing the impact measurement provisions of a SIB contract:

- What to measure?[52]
- When to measure?
- Who should measure?
- How to measure?
- Who should pay for it?

[51] When using rate cards, the public sector commissioner identifies outcomes of interest upfront and sets the maximum amount it is willing to pay per beneficiary for those outcomes, turning SIB set-up into a bidding process.

[52] See section 4.1 Definition of expected results for answers to the questions on 'What to measure?' and 'When to measure?'

Social impact measurement can be done:

- By a credible external independent evaluator (e.g. a university) usually paid by the public sector commissioner but agreed by all parties at the initial contracting stage.

  When SIBs or other outcome payment mechanisms are financed under ESIF, technical assistance can work as a neutral payer, minimising costs for the SIB and the risks of capturing external evaluators. This is important as evaluators tend to rely on long processes and expensive methodologies (e.g. cross-section or time series estimates, or difference in difference 'DID' methods, supported by panel data or control groups in randomised control trials) to assure robust and less disputable outcome validations, while avoiding errors in impact attribution when measuring outcomes in complex cause-effect scenarios.

- Directly by accessing public data (e.g. by running queries on official statistics), when outcome metrics are already available with the required level of detail (or can be easily developed based on existing data), both for outcome contracting and later data collection. In this case, particular attention should be paid to data access permissions, security, privacy and personal data protection.

When using ESIF to pay for SIB outcomes, special attention must be paid to project duration. An extension of the standard 1 to 3 year ESIF project duration must be considered as SIBs are often more long-term projects, with validation and payment sometimes long after the end of the social intervention.

Box 2.9: Checklist

MEASUREMENT METHODS:

- Should an external evaluator be used to measure and validate outcomes?
  - What methodologies should be adopted? Should they be supported by panel data or by control groups in randomised control trials?
  - Who should pay? The public sector commissioner? The SIB consortia (social investors, implementing entity, …)? ESIF technical assistance grants, as a way to reduce the transaction costs for SIB stakeholders?
- Should public data be used to measure and validate outcomes? Are they adequate (scope, level of detail, periodicity)? Under what conditions can they be used?

03

Social Impact Funds (SIFs)

03
Social Impact Funds (SIFs)

3.1
Key features

This chapter addresses the role of SIFs in SII, with a specific focus on the role that public financial institutions could play in promoting and managing these vehicles.

SIFs invest in social businesses via equity and quasi-equity instruments, often providing *mid and long-term* financial support to social businesses for:

- start-up and early stage development, team reinforcement, marketing and commercial expenses,
- growth and scale up, including development of the business and other markets,
- businesses with structural cash burning.

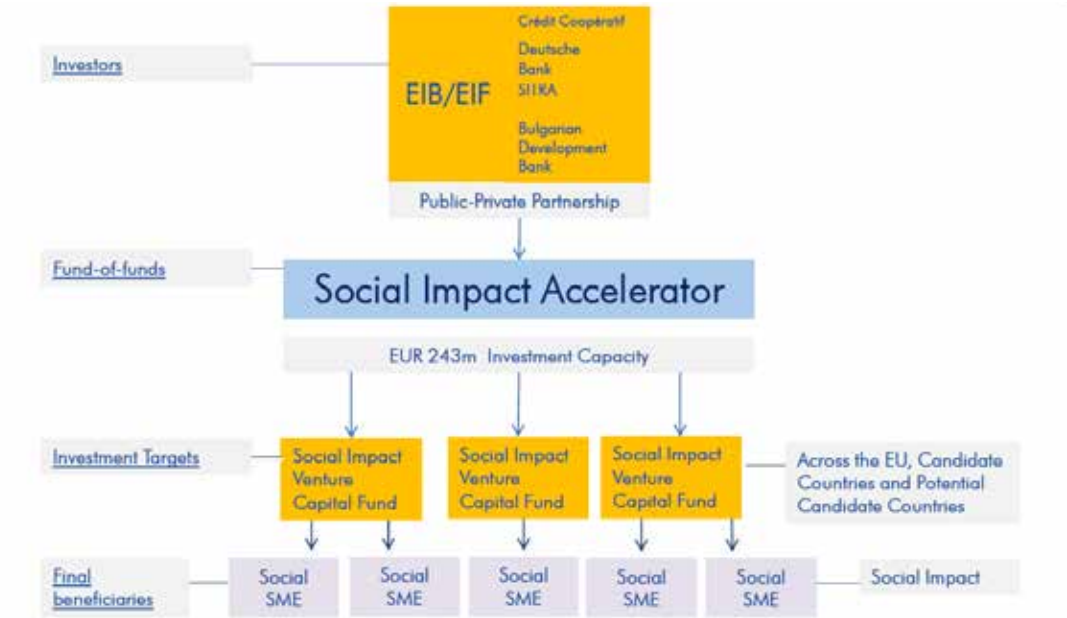
Unlike debt financing, equity financing via SIFs is combined with managerial support and coaching, network and partnership development, as well as additional opportunities. SIFs may be combined with debt financing, crowdfunding and peer-to-peer lending during the different stages of development for social businesses.

A pivotal role in the development of a (still small) SIF industry has been played by the EIF, in particular through its Social Impact Accelerator. This is the pan-European public-private partnership addressing a growing need for equity finance to support social enterprises which at its first closing reached its target of about EUR 250 million. This fund of funds supports the development of SIFs as it invests in funds which strategically target social enterprises across Europe. The fund has invested over EUR 100 million in 11 impact funds[53] across Europe.

[53] Source: EIF, http://www.eif.europa.eu/what_we_do/equity/sia/index.htm.

Public financial institutions haven't so far used SIFs in an integrated strategy to support social businesses. They encourage private investors and intermediaries to support social businesses, but do not intervene directly in the market. This chapter offers a guide to public financial institutions on options, opportunities and ways to manage operational and financial risks to facilitate the development of initiatives in this area.

Figure 3.1. Structure of the EIF Social Impact Accelerator



Source: EIF, https://www.eif.org/what_we_do/equity/sia/index.htm

3.2
Market assessment

The use of public funds for social investment must be based on a strong rationale, so the starting point for this process is to determine the existence of market failures.

This requires a market analysis at the appropriate territorial level covering the demand side, the supply side, and the financial intermediary ecosystem. An initial study must focus on identifying market failures, suboptimal investment situations and investment needs for this policy area.

Box 3.1. Checklist for market assessment

An indicative list of steps for a comprehensive market assessment:

- Are there any existing market problems in the social sector?
- Is there a gap between demand and supply of capital? Is it quantifiable?
- Are there additional public and/or private resources to be raised? What is the estimated leverage?
- Were there similar experiences in the same region? What were the main success factors or barriers?
- What is the added value of the intervention? (quantitative and qualitative estimates)
- Are there alternative approaches and which has the most added value?
- Are there other forms of public intervention addressing the same market problem? If yes, is the intervention consistent with them and not overlapping?

3.2.1 Demand

A study of the demand side brings evidence of impact investment final beneficiaries. It includes local stakeholders, with a specific focus on third-sector organisations, social enterprises (as defined above), and impact-oriented corporations. Additionally, assessing impact-demand players, including public administration and consumers, could be relevant. Any accelerators, incubators and support centres in the region can be a valuable source of information.

The initial aim of this study must be to define the current status of these stakeholders, and should include:

- Potential demand. The study must assess the size of the sector with its thematic and geographical distribution. For example: Are they concentrated in one or several towns/cities? What are the main areas of intervention? How have the organisations evolved recently?

- Any key restrictions to financing working capital, growth or research and innovation. This requires a qualitative study of potential recipients, with interviews or on-line questionnaires.

- If there are persistent restrictions for a specific line of finance, the study must identify specific technical restrictions, such as lack of managerial capability, overwhelming administrative burden, lack of awareness or information regarding impact investing, or strong dependence on grants. Other restrictions could be low profitability or a lack of bankable projects.

This study can be based on quantitative and qualitative techniques and some are identified in the box below.

Box 3.2. Detail of demand analysis techniques

Quantitative techniques	Qualitative techniques
- Statistical series - ROE Analysis (Dupont Analysis) - Inference techniques - Surveys	- Structured and semi-structured interviews - Focus groups - Secondary research

A combination of quantitative and qualitative techniques offers a panoramic view of the demand. The size of the target population, sector or geographical area could make statistical analysis less suitable than surveys and a field qualitative approach (e.g. case studies). However, quantitative techniques can offer more precise analysis when data is available.

Any quantitative description can also be used for comparisons with other regions that have similar characteristics or other sectors or target groups (non-impact firms or organisations) and can be useful to establish potential funding gaps. An example of a potential target group might be final recipients of SII interventions. These are part of the demand which is considered in the market assessment. Some examples are in the box below.

Box 3.3. Detail of potential target groups

Social needs differ for potential target groups of SII interventions, such as:

Unemployed and NEETs: Job creation, to reduce dependency on welfare and build the capacity of a person to pay for their own future pension and care.

Students, schools/universities/research centres: Support to youth and adult education, well–educated people have more chances to find new and better jobs;

Disadvantaged people: Reducing social exclusion and increasing the chances of finding a job for people with disabilities, ex–convicts and recovering alcoholics or drug addicts reduces their dependency on welfare and contributes to their future.

Migrants: Job creation, to diminish their dependency on welfare and possibly also reduce social tensions. Migrants in EU countries show an increasing need for financial inclusion.

Women: Better job opportunities and increased entrepreneurial initiatives would also contribute to gender equality and social inclusion.

Several comparative indicators can be based on specific metrics such as projects per capita, survival rate after five years and financial metrics like leverage, capitalisation and number of employees.

The analysis should produce a map of the demand actors, their main features and a hypothesis of market failures.

Box 3.4. Checklist for a demand side analysis

Understanding the current status of stakeholders from the demand side:

- What is the potential demand in terms of sector size, thematic and geographical distribution?
- Are projects encountering restrictions for financing?
- Are there any other technical restrictions that compromise the financing?

Identify the best research method to study the demand side:

- What is the best research technique to obtain information? Deciding on quantitative or qualitative researching techniques, or a combination of both.

3.2.2 Supply

A study of the supply side for impact investing should detail market failures and suboptimal investment. Supply side actors must be identified with a focus on public and private sources of finance, including the EU, as well as national, regional and local authorities. Private financial sources can include commercial and investment banks, venture capital funds and business angel networks, family offices and corporate foundations.

The parameters for impact investment of these actors should also be detailed, including the amount delivered at regional and national level, distribution, thematic orientation and recent evolution.

As each supplier may specialise in a different investment strategy, the study will need to clearly identify current trends for different financial products (equity, loans, guarantees, etc.) with each portfolio management and investment strategy, including eligibility criteria and risk management systems.

A key element to be reviewed must be impact measuring and monitoring, and the different systems used by investors should be identified.

Suboptimal investment situations can be identified through the key supply side restrictions. Low investment can be due to risk-return considerations, a lack of attractive projects or a lack of project maturity.

These parts of the study must assess available funding for impact investing, including finance to cover working capital, growth, seed funding and research, development and innovation.

As in the demand side analysis, the aim is to identify the key features of the supply side and restrictions to impact investing, using both quantitative and qualitative methodologies. These can include time series, comparative analysis, and in-depth interviews.

Box 3.5. Checklist for a supply side analysis

Establish a map of supply side actors:

- Is there any EU, national, regional or local authority providing social impact funding?
- Are there any private financing sources (such as commercial and investment banks, venture capital funds, business angels, family offices or corporate foundations)?

Assessing the supply side and investments:

- How much impact investment is delivered by these actors?
- What is the geographical and thematic orientation of the investments?
- What financial products are offered and the criteria for acceptance?
- Is there any impact measurement system?
- What key supply side restrictions are encountered by the actors?

Identify the best research method to study the supply side:

- Which research technique gets the most valuable information? Use quantitative or qualitative research techniques? or a combination of both?

3.2.3 Financial intermediary ecosystem

In addition to the demand and supply sides, it is critical to have a clear vision of the financial intermediary ecosystem, which is key to the development of appropriate public intervention. This should include both supply and demand considerations, as well as knowledge management, externalities and network effects.

Actors to consider for SIFs include venture capital general partners, accelerators and incubators, business angels, consultants and advisory organisations, universities and business schools.

Intermediaries are useful when identifying the key market elements on both demand and supply sides, as well as the market failures related to transactional costs.

Key aspects to be examined include the density of the financial intermediary ecosystem, including the number of agents, their experience and quality of intermediation, their ability to generate an appropriate deal flow and to attract private and public investors.

This assessment must also identify the difficulties of working with the impact and social sectors. Common difficulties relate to a lack of capacity to generate appropriate investment projects, high transactional costs and the risk-return balance.

Although quantitative data can be relevant, most of such information comes from interviews and other qualitative techniques like focus groups, Delphi methodologies and open surveys.

Box 3.6. Checklist for analysing the financial ecosystem

The intermediary ecosystem:

- Can we identify any intermediaries?
- Do these have any experience with impact investing funds?
- Could they generate an appropriate deal flow?
- Could they attract private and public investors?
- Are there any restrictions on access to the intermediary ecosystem (e.g. transactional costs; risk-return balance)?

Identifying the best research method to study intermediaries:

- What research technique gives the most valuable information? Quantitative or qualitative research techniques? or a combination of both?

3.2.4 Crowdfunding

Crowdfunding is a relatively innovative way of financing projects. It is based on a digital platform where users can choose from different projects to be funded with small contributions. While the individual amounts are small, many contributions can draw significant amounts of money to each project. The main value of these platforms is to lower transaction costs, reduce informational asymmetries between individual investors and projects, and distribute potential risks among the sponsors. It promotes the use of new technologies, social networks and online payments, thus increasing the community digitalisation. Additionally, in most EU countries, crowdfunding platforms are regulated to avoid fraudulent transactions, or fictitious projects

Accordingly, crowdfunding could be a viable and interesting model to finance social impact projects, since it allows citizens looking to achieve social goals to invest in or contribute to projects that could generate a social return. Contributors can decide which projects they want to allocate their savings to, while the platform guarantees the quality of projects. Additionally, individual contributors may benefit from any tax deductions in their country of residence.

These platforms also provide an opportunity for cities and municipalities to collaborate closely and be involved in the planning phase of projects, adding an additional social dimension. Entrepreneurs and companies also can test their ideas before investing larger financial resources.

In Spain there is the first online platform for participatory financing of a public administration. 'Crowdfunding Bizkaia' was launched by the Provincial Council of Bizkaia (Basque Country) to bring together promoters and investors who are committed to projects with social impact and / or innovative components.[54]

Crowdfunding Bizkaia validates projects through economic and financial analysis while also advising on the content of projects. Once approved, the platform publishes the project for investors to review and provides a place for communication between promoters and investors.

[54] https://crowdfundingbizkaia.com/

A social investment fund can contribute to development of these platforms. The large number of relatively small amounts make it difficult to match every transaction, so co-investment with this kind of platform must be based on a minimum amount of private funds. One strategy can be to establish a threshold which triggers SIF co-investment.

As an example, an SIF could fill the gap if the crowdfunding platform reaches a minimum level of funding for a project (e.g. 80%). This can prevent increased administrative burden and can be an incentive to enhance the platform's effectiveness. Co-investment must be properly designed to mitigate administrative and eligibility risks.

3.2.5 Rationale for public intervention

Once there is a complete vision of demand, supply and intermediation, the study should define the market failures and then the rationale for public intervention.

Market failures

These failures are where market forces do not deliver optimum investment.

Table 3.1. Most common impact investment market failures

Market failure	Explanation	Example
Positive externalities	Private agents do not provide enough funding, as some economic effects generated by the impact investments are not translated into prices, while costs are.	A social entrepreneur aims to provide employment to people with disabilities. Market prices do not integrate the positive social effect of labour inclusion.
Informational Asymmetries	Demand and supply sides do not share the same information relating to the viability or scalability of a project.	A new social venture provides an innovative solution to urban pollution, but investors do not have enough information to risk investing in it.
Risk aversion	Supply side prefers to invest in projects with a track record, avoiding investments in other projects with higher risk.	Investors prefer to invest in late-stage social ventures, which are less risky, while most early stage ventures do not grow due to a lack of funding.
Transaction costs	Transaction costs for demand or supply are too high to facilitate investment	A fund is looking for new opportunities, but the social projects are too small to attract new investment. Lack of appropriate intermediation complicates the match between supply and demand.

Market assessment must provide evidence of these market failures based on field and desk research conducted in the earlier steps. It must be as precise as possible, including the main elements for establishing such failures.

One method can be a simple and effective analysis to identify the most relevant strengths, weaknesses, opportunities and threats (SWOT). It distinguishes between strong and weak points, both internal and external to the ecosystem, including actual and potential factors.

Figure 3.2. SWOT Analysis

Strengths	Weaknesses
– Internal – Actual	– Internal – Actual
Opportunities	**Threats**
– External – Potential	– External – Potential

Suboptimal investment situation and funding gap

Suboptimal investment results from market failures and leads to a funding gap when a regular market is unable to deliver the funds needed to reach preferred social and economic targets.

The funding gap is the difference between the expected need and the available funding, which can be identified in various ways.

Table 3.2. Assessing the funding gap

Approach	Explanation	Related market failures
Unmet demand	Demand for impact investing is higher than supply. Evidence shows that funding needs of viable and bankable projects are lower than actual investments, due to rejected transactions.	Risk aversion (supply) Informational asymmetries Transaction costs
Unmet supply	There are more funds available than disbursed due to a lack of applications.	Lack of intermediation Transaction costs Risk aversion (demand)
Benchmark to reference	Investment is lower than expected compared to regions and sectors with similar size and characteristics.	Externalities Risk aversion
Gap to target	There is a public policy target and not enough funding to meet it.	Externalities Transaction costs Risk aversion

Assessment of the added value

Public intervention in the market must be based on the initial market assessment and a determination of market failures, sub-optimal investment and funding gaps. Given a clear and precise vision based on this rationale, the next phase is to assess the added value and the rationale for public intervention.

This assessment must be both qualitative and quantitative. For the qualitative aspects, it is important to clearly specify what value the fund will generate from tailor-made funding for social ventures in the region, attracting new specialised intermediaries, sharing risk with private investors, providing early stage funding, etc.

Quantitative aspects relate to:

- expected total leverage, specifically of EU funds, related to total final recipients;
- intensity of subsidy (if any);
- revolving effect of the instrument;
- estimated additional contributions from private investors.

Determining **qualitative added value** is less straightforward. Nonetheless, some aspects may recur with social investment, for example:

- **Exploring new forms of support** for the social sector or new for the country/region (e.g. SIBs) is already a value added.
- **Improving the capacity of investment** and knowledge in the social sector in the country or region adds value.
- **Favouring revolving long-term support schemes** in a sector like the social economy where access to finance is traditionally an issue, has the added value of supporting future recipients with the same funds.
- **Attracting financial know-how** (e.g. from intermediaries and co-investors) to a sector where such expertise is often lacking.
- **Capacity in recipients and society.** Investment anticipates a return of at least some of the support, which requires a greater understanding of financial flows (e.g. through a business plan) for those involved.

This added value must be compared with other public policy alternatives, to provide a sound understanding of the financial instrument rationale.

Policy coherence

The proposed financial instrument must be coherent with other public policy instruments, avoiding cannibalisation and inconsistencies in public policy intervention. Reviewing the coherence between the financial instrument and the public policy framework is critical at that juncture, including consistency with ESIF operational programmes.

In that sense, the market study must take into account the interactions and spillover of different policy programmes and clearly define the consistency with ESIF operational programmes, including the instrument's thematic objective and investment priority.

There are no significant differences in adopting ERDF or ESF financial instruments beyond the policy objective and the goals. Even if ERDF and ESF can directly or indirectly pursue social goals, some thematic objectives are particularly appropriate for direct and streamlined SII (see **Table 3.3**).

Table 3.3. ESI Funds, thematic objective and priority specifically relevant for SII

ERDF	TO1	Financial instruments aimed at supporting innovative entrepreneurs can strengthen research development and innovation by promoting social innovation as a source of growth and jobs.
	TO3	Financial instruments that promote entrepreneurship and the creation of new businesses through business incubators targeted at disadvantaged groups or the young can enhance competitiveness of SMEs and address various social issues.
ESF	TO8	Financial instruments tailored to the creation of SMEs or micro-enterprises can have financial returns that potentially attract co-investment and tangible spill-overs in the local economy, in addition to the social benefits.
	TO9	The leverage effect of financial instruments can bring additional resources for combating poverty and integrating public support for social inclusion, which is insufficient in most Member States due to fiscal constraints. Financial instruments can increase the efficiency of social services for disadvantaged groups, reducing public spending.
	TO10	Financial instruments may attract additional resources so students can reduce education costs. Investing in education raises skills and offers the potential for finding better jobs. Young people from disadvantaged backgrounds may be especially encouraged to study more.

Box 3.7. Checklist for determining the rationale for public intervention

1. **Analysing market failures and suboptimal investment situations:**

- What are the most relevant strengths, weaknesses, opportunities and threats for the public intervention?
- When identifying market failures, are there any positive externalities, informational asymmetries, risk aversion, transaction costs?
- What is the market funding gap? Is there any unmet demand, unmet supply, benchmark or target gap?

2. **Assessing added value:**

- What qualitative value will the SIF generate (e.g. new intermediaries, early-stage funding; sharing risks with investors)?
- What are the quantitative aspects of the fund (e.g. expected leverage, revolving effect, subsidy intensity, additional private contributions)?

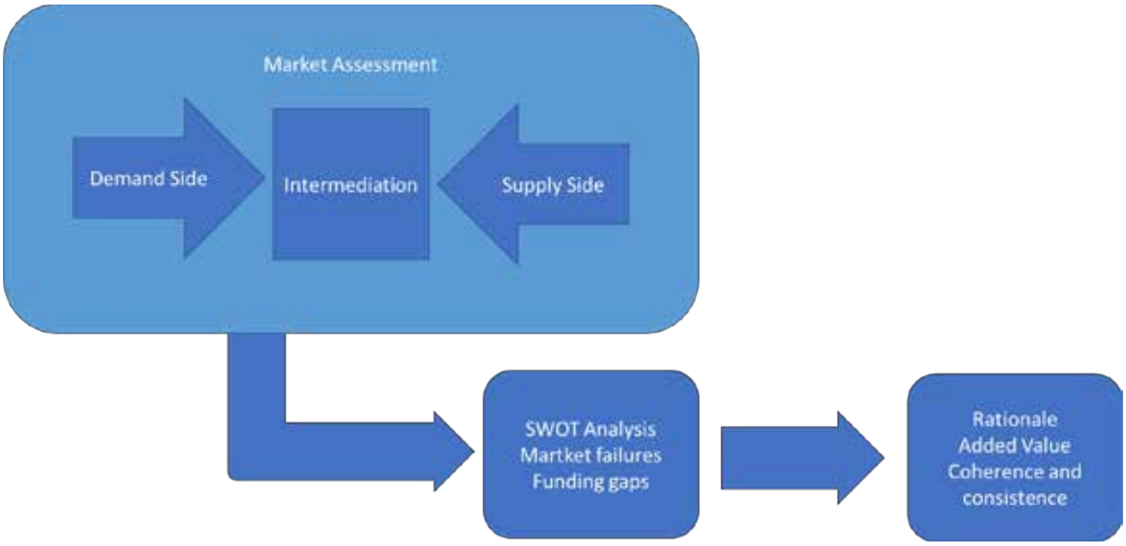
3. **Understanding the coherence with other public policies:**

- Do other public policy instruments address the same market?
- Is the SIF consistent with these policies and does it avoid cannibalisation?

The figure below shows the whole process of designing the instrument's architecture.

The main steps are a market analysis, a SWOT assessment, assessment of market failures and suboptimal investment, identification of added value and checking consistency and coherence with the policy framework.

Figure 3.3. Process of designing an instrument's architecture



Source: Red2Red elaboration

3.3
Delivery and management

3.3.1 Investment strategy

The investment strategy typically emerges from:

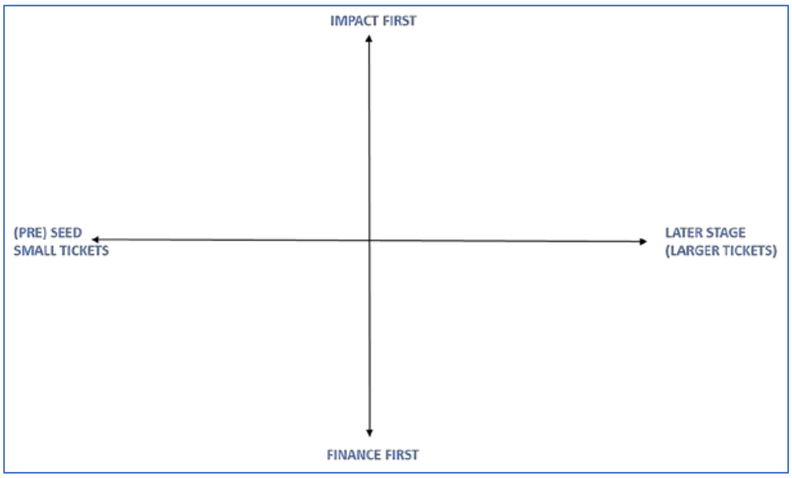
- Demand side (financial market) opportunities and threats, in particular the sectors, business maturity, investment readiness, scalability and attitude to innovation;
- Strength and weaknesses of promoters and allied parties, in terms of market presence and recognition, non-financial support and exit strategy implementation;
- Regulatory constraints, shaping for example the fund structure, types of instruments to be deployed, fund duration and partnership framework;
- Investor long-term objectives (social and financial).

Box 3.8. Detail for financial and impact investment markets

Financial markets	The dominant variables are risk and return. Higher risks require higher returns, and lower returns are only acceptable when the risk is very limited.
Venture capital and private equity	Other fundamental variables are transaction costs and asymmetries of information. Small investments entail relatively high transaction costs (related to the entire investment cycle: deal flow generation, identifying potential targets, due diligence and negotiation, deal execution, portfolio management, exit management). From a pure efficiency and Internal Rate of Return perspective, larger tickets are preferable to small ones and small tickets often fall into a market failure area. Asymmetry of information is another cause of market failure, as it may reduce innovation in the investment industry and disincentives for investment in less known targets and markets.
Impact investment market	Two core components must find a balance: the social return and the financial return. Social impact may be the primary objective of a financial vehicle ('impact first') or, alternatively, financial reward is the core component ('finance first') and social impact is a secondary (and measurable) objective.

To define a fund's strategic objectives considering these issues, the promoter and partners may use the following chart in a workshop. The horizontal axis summarises issues related to transaction costs and part of the risk reward component. The vertical axis summarises the priority assigned to financial versus social objectives. Depending on the markets, this chart may be also used to identify market failures on which a regional financial agency may focus (part of) its distinctive and public action.

Figure 3.4. Defining fund's strategic objectives



Source: Avanzi elaboration

Once the strategic objectives are clarified, defining an investment strategy for an SIF should involve clarifying the fund objectives, as detailed in the table below.

Table 3.4. Proposed template for identifying and defining the fund strategy

Fund objective	Description
Target companies *(including sectors or social priorities)*	
Minimum and maximum fund size	
Minimum and maximum investment ticket and possibilities for follow-ons	
Number of deals, number of write-offs and portfolio	
Average holding period	
Type of financial instrument(s)	
Non-equity support, *(managerial support, catalytic grant, debt, guarantees or other)*	
Fund duration	
Management fees	
Exit strategy	
Expected internal rate of return	
Financial value drivers	
Expected social impact	
Social impact drivers	

Box 3.9. Checklist for defining an investment strategy

- What are the core elements for the investment strategy relating to target recipients?
- Similarly, what are the core elements and value proposition for co-investors and strategic partners?
- What is the strategic position in the market, at launch and in the following years?
- What strategic challenges will SIFs pose to the managing authority and the regional investment agency?

Typical investment areas for an SIF

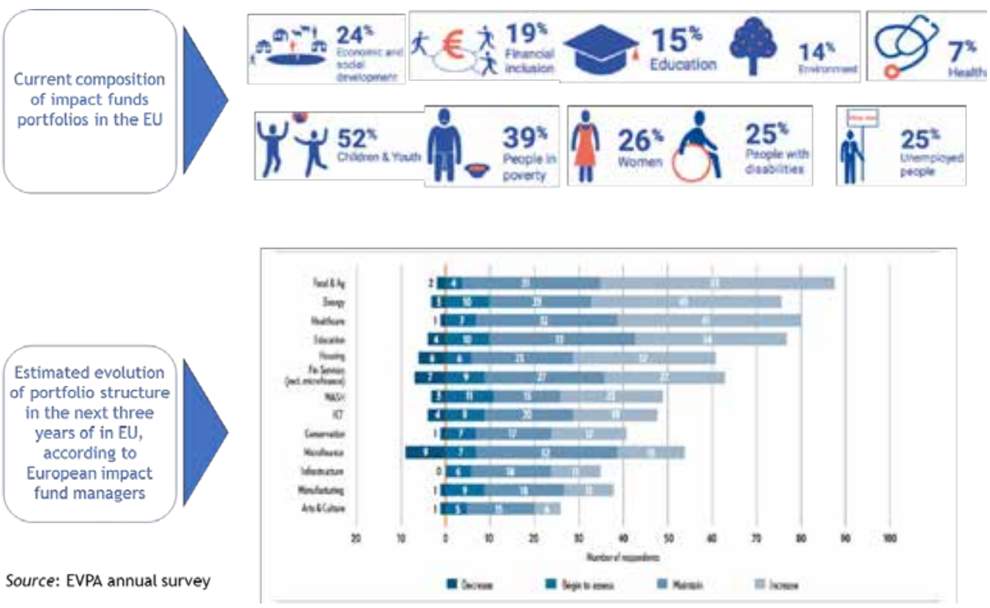
Considering the newness of impact investing and the typical broad approach of most of the venture capital and private equity industry, virtually all current SIFs invest in a variety of sectors or social priorities. Periodically, the European Venture Philanthropy Association surveys active impact investors in Europe, including on current and future priority areas.

There are multiple priorities (above) and market sectors (below) and as part of defining an investment strategy, these two elements may coexist:

- priorities are more directly linked to the impact nature of the funds and may keep the strategy closely linked to the social evaluation framework;

- sectors are more linked to the traditional taxonomy of the economy and may enable simpler identification of target recipients, deal flow sources and exit options.

Figure 3.5. Combination of priorities and market sectors.



Source: EVPA, 'Investing for Impact - The EVPA Survey 2017/2018'

Types of financial instruments

The various financial instruments depend on the jurisdiction, type of company, interest of the SIF and the investee but they are normally:

- **Equity**. Investments in company shares:
  - As a single commitment, in one or more tranches;
  - As more than one commitment in the same company, in follow-on investments (each in one or more tranches).

Shares normally include ordinary and extraordinary voting rights and, depending on the contractual arrangements, on any closure of the business, the investor is paid out once senior and junior creditors are paid.

- **Quasi-equity**. This includes instruments such as convertible notes/debt, mezzanine financing, preferred stocks, structured equity.

Quasi equity normally entails limited voting power, regulated in specific contractual arrangements, and repayment similar to a debt (junior rather than senior debt). In recent years, quasi-equity has significantly developed as it allows an injection of risk capital for a specific target, without diluting existing shareholders. Dilution only occurs when the investee is not able to fulfil their repayment obligations. Quasi-equity is very interesting especially for investments in cooperatives, where voting rights only partly protect equity investors.

Collective investment, i.e. crowdfunding, may be similar to equity investment or quasi–equity investment, in terms of preferred stocks and limited voting rights. To compensate any asymmetry of information between investee and investor, there are now specific regulations on crowdfunding in different EU countries.

Key actors

Structuring a fund is not easy and various success factors suggest engaging other actors in the ecosystem including:

- existing funds;
- advisors;
- incubators and accelerators;
- deal flow partners;
- equity crowdfunding platforms.

Engaging these actors may involve a partnership scheme, with broad and specific features shaped in relation to the market assessment, funding strategy, expected role in the ecosystem for the regional funding agency and the following four important elements:

- Funds availability and economic sustainability[55];
  - A standalone initiative requires a sustainable fund size to pay the initial set up and especially running costs. Depending on the jurisdiction, the minimum fund size could be EUR 20 to 30 million;
  - Compartment in an existing fund or fund of funds management company may need EUR 10 to 20 million. The implications on decision-making, autonomy of the initiative, voting rights (including veto rights) should be carefully examined with a legal firm;
  - Mandates investing in existing third-party funds and *pari passu* schemes could require less funds, with a minimum of around EUR 1 to 2 million.
- Funds destination, especially ERDF, ESF and other public funds, may be targeted to certain schemes;
- Internal capabilities. The promoter's internal skills (and availability) may not be sufficient for an initiative that requires a high degree of expertise and dedication. In addition to venture capital or private equity skills, it is important to stress that other capabilities may need to be activated and deployed including entrepreneurship, management, social business, deal flow generation, networking and partnership or social impact measurement (see also Chapter 3.4);
- Authorisation process and requirements. This may dramatically influence the time to market and, if authorisations are not already available, may suggest the involvement of co-managers or third parties to run the initiative.

The following box presents questions providing guidance on areas of mutual interest to be explored in order to design a long-term partnership.

Box 3.10. Checklist for the partnership model

1. EXTERNAL FACTORS:

- Who are the relevant actors in the local ecosystem?
- Are they already active in impact investing?
- Is the regulatory framework particularly demanding in terms of time for authorisation and compliance-related costs?

[55] Please note that ERDF and ESF funds could be integrated with other sources coming from private and governemental organisations. These partners could be engaged under the same conditions as the promoter, namely with the same risk return profile, or by offering particular advantages:

- *down-side protection*, protecting co-investors in case of loss
- *up-side leverage*, offering co-investors privileged access to any capital gain
- *facilitation to exit*, for any co-investment, that operates similarly to the down-side protection scheme.

The regional financing agency and / or the managing authority may consider involving the EIF as a co-investor. Any discussions with the EIF should be in the design phase, as the EIF has strict rules in terms of impact, risk, return, governance and expertise.

2. INTERNAL FACTORS:

- Are the available funds sufficient for a stand-alone initiative?
- What is the expected maximum time to market?
- Does the regional financing agency have strong expertise and a team for the initiative?

3. DOUBLE SIDED VALUE PROPOSITION:

- What value is offered by the regional financing agency to actors in the ecosystem? Funds, expertise, pipeline, exit opportunities, other supporting activities, return, risk mitigation, …?
- What value can organisations in the ecosystem offer to the regional funding agency initiative? Funds, expertise, pipeline, exit opportunities, other supporting activities, return, risk mitigation, …?

Figure 3.6 shows three fund options that may be considered when structuring an SIF initiative: directly managed, co-managed or indirectly managed and includes five sub-options:

- Sub-Option 1 is a traditional stand-alone fund or an independent compartment in an existing umbrella fund, investing with a geographical scope compliant with the promoter's (financing agency) activity boundaries. This option requires (at least):
  - Strong internal expertise
  - A team for the initiative
  - Time (for the authorisation process)
  - Attractiveness for potential investees
  - A solid network for recipient strategic development and for managing the exits
  - Funds (at least EUR 20 million, and EUR 10 to 20 million to be acquired in the market).

- Sub-Option 2 is a joint venture/consortium with different financing agencies, with pooled resources and a dedicated fund and governance that allows joint management with the promoters and (at least):
  - Strong internal expertise
  - Time for the authorisation process and for co-designing and co-deciding with other regional funding agencies
  - Attractiveness for other regional financing agencies, including a willingness to operate within a shared governance scheme
  - Attractiveness at multi-regional level for potential recipients
  - A combined, multi-regional network for recipient strategic development and for managing the exits
  - Funds (at least EUR 20 million, and EUR 10 to 20 million to be acquired in the market).

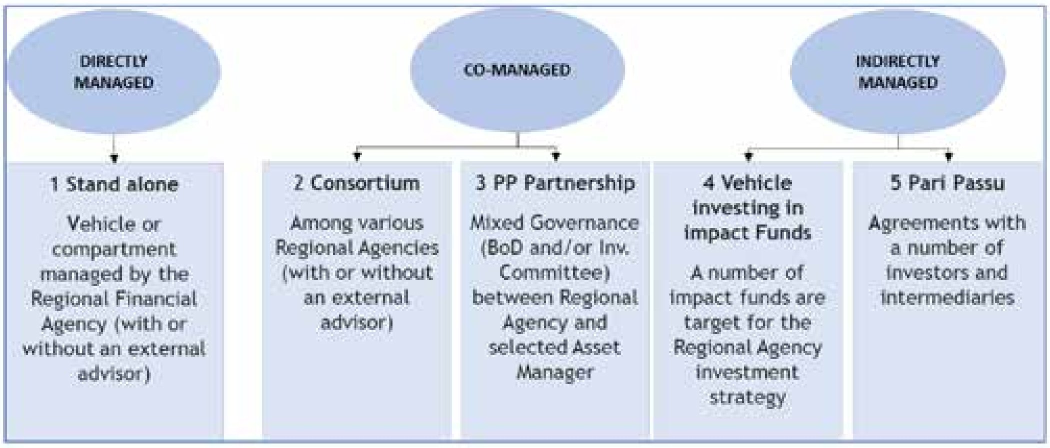
- Sub-Option 3 is a public-private partnership, with a dedicated vehicle co-managed by a private fund and the financing agency. Both are promoters and participate in decision making (at least on the board). This option requires (at least):
  - Solid internal expertise (alternatively, to be acquired via consultants) for selecting a fund manager
  - Attractiveness for (candidate) asset managers, including the willingness to operate within a shared governance scheme

  - Vision and expertise to actively participate on the Board of Directors and / or investment committee
  - Funds (at least EUR 10 but it may need EUR 15-20 million in total to be sustainable, depending on the cost structure and compliance to be carried out)

- Sub-Option 4 is a mandate investing in various impact funds selected by the financing agency. The funds may be similar or, where impact investing is more mature, in different domains (sectors, maturity stage), or use different vehicles. This option requires (at least):
  - Internal expertise and a small team (alternatively, to be acquired via consultants) for selecting fund managers, negotiating deals and monitoring activities
  - Limited funds (EUR 5 million could be enough)

- Sub-Option 5 involves contractual arrangements with funds and investors, where the financing agency commits to invest once the investor selects and co-invests in a target compliant with pre-defined features. This option requires (at least):
  - Internal expertise and a small team (alternatively, to be acquired via consultants) for selecting fund managers, negotiating deals and monitoring activities
  - Ability and licence to directly act as shareholder in recipients or possibility to create a dedicated holding structure
  - Limited funds (EUR 5 million could be enough)

Figure 3.6. Possible management options



Source: Avanzi elaboration

3.3.2 Possible combination of support (with grants or with other measures)

In addition to the above, when structuring a fund, the promoter may also provide non-equity support including a market assessment or, during the life of the fund, receive feedback from prospects or recipients).

The needs for a market assessment as described in Chapter 3.2 could relate to three phases. The table below may assist an identification of needs and related support that the regional financing agency could provide by expanding the range of instruments or as side offers to the (potential) recipients.

Box 3.11. Checklist to design non-equity support

- Are there non-equity forms of direct and indirect support to social businesses that could be deployed by the regional financing agency?
- What instruments could catalyse energy and expertise in place?
- What areas of expertise in the regional financing agency are different to other actors in the ecosystem (including recipients)?

Table 3.5. Proposed template for identifying needs and related support

	Capacity building	Product – Service design optimisation	Organisation, management, IT	Marketing, commercial	Scale up, partnership, internation-alisation	Debt and guarantees	Fund raising
Prior to investment							
During the investment							
In the exit and post exit phases							

Once the needs have been clearly identified, possibly using statistics, interviews and focus groups, the non-equity support can be structured. This can be based around grants and innovation vouchers, with training and coaching, incubation and acceleration services, networking and partnership management, business development support, partnerships with other investors, specific debt and guarantee schemes.

Where impact investing is well-developed with a wide spectrum of actors and schemes, non-equity support may be of a particular value, as a catalyst for initiatives already in place. It should also be noted that the non–equity support could:

- Be deployed within ERDF and ESF rules,
- Be more familiar for the regional financing agency, in comparison with equity schemes,
- Require a very short time to market,
- Support the initiatives of multiple intermediaries.

3.3.3 Procuring the SIF

Compliance with public procurement regulation is key to swift implementation of an SIF. Public procurement procedures per EU Directive 2014/24 include:

- Traditional schemes, i.e. 'open procedure' and 'restricted procedure'.
- Innovative schemes, i.e. 'competitive dialogue', 'competitive procedure with negotiation' and 'innovation partnership'.

The relatively new financial approach to tackle social problems encourages innovative public procurement schemes. This is because complex problems need in-depth analysis and the contracting authority cannot rapidly establish all the specifications.

For more detail, public procurement procedures have been described in Chapter 1.3.2.

3.3.4 State aid compliance

As the SIF is intended to generate support for the private and social sector, the design must take into account the State aid provisions in article 37 of Regulation 1303/2013.

As extensively explained in Chapter 1.3.3, State aid is an advantage in any form conferred on a selective basis to undertakings by national public authorities. An analysis of State aid must be carried out to avoid the SIF contravening the EU Treaty.

The basic checklist to determine any need for an in-depth analysis on State aid is:

1. Is the support granted by the State or through State resources?
2. Is the recipient an 'undertaking'?
3. Does the support confer an advantage to any undertakings over others?
4. Does the assistance distort competition, and does it affect trade between Member States?

If the answer to all the above-mentioned questions is 'yes', then a regulatory route to compliance should be used. The box below describes an example of State aid considerations for a guarantee financial instrument.

Box 3.12. Example[56]

Analysis of State aid implications

Capped guarantee for social enterprises

An ESIF managing authority implements a guarantee scheme to support individuals involved in creating new ventures for social purposes who lack the collateral to obtain finance.

Implementation is entrusted to an International Financial Institution (IFI) as a fund of funds manager and guarantor. The IFI does not provide financing directly to social enterprises, but offers capped guarantees to financial intermediaries, which in turn disburse new loans to final recipients. The guarantees are free of charge (e.g. no guarantee fee), and the financial advantage is transferred completely to final recipients. Financial intermediaries are selected by the IFI on the basis of open, transparent, proportionate and non-discriminatory procedures, avoiding conflict of interest.

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[56] See: fi-compass.it, 'European Social Fund financial instruments and State aid'

The capped guarantee fund of EUR 20 million covers up to EUR 100 000 of new loans for each financial intermediary and 80% on a loan-by-loan basis with a cap of 25% of the portfolio.

For the **fund of funds** there is no State aid, as the IFI is remunerated at market level through management fees within the limits set by the CPR.

1. At the **level of financial intermediary** there is no State aid, because the guarantee is free of charge and the full financial advantage is passed on to final recipients as reduced interest rates and/or collateral requirements.

2. At the **level of final recipient** there might be State aid, as social enterprises are undertakings in the sense of Article 107 of the TFEU and receive an advantage they would not obtain under normal market conditions in the form of sub-commercial borrowing terms.

Therefore, a State aid compliance path should be sought.

The regulations on financial instruments provide different compliance options, i.e.:

- respect the *de minimis* regulation;
- fall under the general block exemption regulation (GBER);
- be an off-the-shelf financial instrument;[57]
- be notified to the EC.

For more detail, State aid compliance options have been summarised in Chapter 1.3.3.

For SIFs one way under the GBER is an asymmetric distribution of losses between public and private investors, where 'the first loss assumed by the public investor shall be capped at 25% of the total investment'.[58]

Such a redistribution of risk should attract private capital when the expected return on individual projects may be lower than other investment alternatives.

[57] Five of these instruments are currently available, see:
https://www.fi-compass.eu/news/2016/07/new-shelf-financial-instruments-business-and-urban-development

[58] General Block Exemption Regulation (GBER), art. 21.13.c)

3.4
Measurement

3.4.1 Measurement of SIF impact

As seen above, measurement is a key element in impact investment. Regrettably, the concept has been so overworked and the term so inflated that there is some confusion. In this context, impact is defined as the contribution an activity generates at societal level to address a social challenge.

Amongst the results of an activity (or project, program, organisation or policy), impact is the most difficult to assess, as it can be influenced by external variables that are not under the control of the subject and cannot always be isolated and discounted. Whilst it is relatively easy to link cause and effect at output level, it is much more challenging to prove this at impact level.

To be credible, impact assessment must be planned as early as possible, ideally together with the business plan and it should guide business design and planning. An impact-orientation process should address:

- What problem are we trying to solve?
- What is our proposed solution?
- Who experiences change as a result? What subgroups are there (or customer segmentation)?
- What changes should happen?
- How can we measure these changes?
- How much change has happened (or is likely to happen)?
- How much change is caused by our activities?
- How long do we need to measure the changes for?
- What is the relative importance of the different changes?
- What changes matter and are important enough for us to manage?

A social business should have a solid theory of change. This is a methodology for planning, participation and evaluation that is used to promote social change. It defines long-term goals and then maps backwards to identify necessary preconditions. The methodology entails a specific and articulated description of activities needed to achieve a given social change, starting from defining long-term objectives and going back to the preconditions and actions.

The theory of change:

- clearly defines the outcomes we want to achieve and how;
- emphasises the reasons intermediate outcomes are important;
- provides the basis and logical framework to identify evidence that can be measured.

In terms of how to account for, measure and manage social value, seven principles should always be considered:[59]

[59] https://socialvalueint.org/social-value/principles-of-social-value/

- Involve stakeholders
- Understand change
- Only include what is material
- Don't overclaim
- Value what matters
- Be transparent
- Verify the result.

According to the UK Social Impact Investment Taskforce,60 impact measurement has four phases:

Table 3.6. Impact measurement process according to the UK Impact Investment Taskforce

Plan	**Set goals**	Articulate the desired impact of the investment. Establish a clear investment thesis/ theory of change which should form the basis of strategic planning and ongoing decision making and serve as a reference for investment performance.
	Develop framework & select metrics	Determine metrics to be used for assessing investment performance. Develop effective impact measurement that integrates metrics and outlines how specific data are captured and used. Use metrics that align with existing standards.
Do	**Collect & store data**	Capture and store data in a timely and organised fashion. Ensure that the information technology, tools, resources, human capital, and methods used to obtain and track data from investees function properly.
	Validate data	Validate data to ensure acceptable quality. Verify that impact data is complete and transparent by cross-checking calculations and assumptions against known data sources, where applicable.
Assess	**Analyse data**	Distil insights from the data. Review and analyse data to understand how investments are progressing against impact goals.
Review	**Report data**	Share progress with key stakeholders. Distribute impact data coherently, credibly and reliably to effectively inform decisions by all stakeholders.
	Make data-driven investment management decisions	Identify and implement mechanisms to strengthen the rigour of investment process and outcomes. Assess stakeholder feedback on reported data and address recommendations to make changes to the investment thesis or theory of change.

Of course, there are different approaches and methodologies for social value assessment. The EC, through its 'Groupe d'experts de la Commission sur l'entrepreneuriat social', pushed the concept of social impact assessment. The European Venture Philanthropy Association proposes a Social Performance approach based on balanced scorecards and ratings.61 The Social Return On Investment Network uses financial proxies to quantify the relative value of outcomes, although social value is not always convertible into monetary units.62 In some circumstances, a counterfactual analysis is required, that is a comparison between what actually happened and what would have happened in the absence of the intervention, through a control group.

All these methods have common aspects and slight differences. Clearly, most of them imply complex processes that are not always applicable to SIFs, for obvious reasons (cost, time, data availability, tech-

[60] http://www.evaluatingimpactinvesting.org/wp-content/uploads/Measuring-Impact-IMWG-paper.pdf

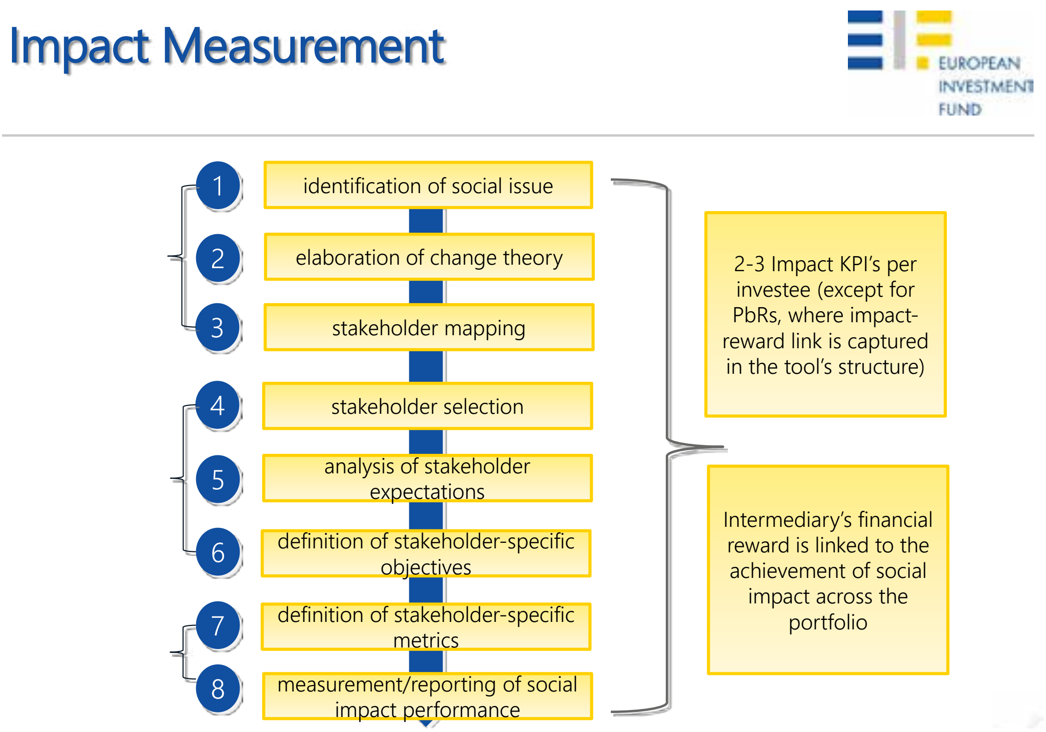
[61] https://evpa.eu.com/knowledge-centre/publications/measuring-and-managing-impact-a-practical-guide

[62] http://www.socialvalueuk.org/app/uploads/2016/03/The%20Guide%20to%20Social%20Return%20on%20Investment%202015.pdf

nical feasibility, etc.). Therefore, a simplified approach is needed. Most impact investors do not actually assess any impact and at best they measure only some outcomes. But it is important to require recipients to adopt an impact-oriented attitude.

The most remarkable player that we have mentioned, the EIF Social Impact Accelerator, has adopted a social impact performance methodology that requires the fund manager to commit to measure and report on impact achieved by recipients. In practice, portfolio companies often agree with the fund manager a few 'impact' indicators and set pre-investment targets for each of them. Fund managers disclose both social impact indicators and pre-investment targets to their investors and at least once a year calculate and report the impact multiple, defined as the comparison between pre-investment target and realised value.

Figure 3.7. EIF Social Impact Accelerator approach



Source: EIF

The approach is important because the financial performance incentive of the fund manager (carried interest) is linked to the social impact performance of the fund. It therefore creates a strong alignment of interest between investors and intermediaries, which should stimulate recipients to optimise their social objective function.

3.4.2 Measurement of Operational Programme impact and indicators

In addition to measuring social impact, instruments financed with ESI Funds must also be compatible with the operational programme framework indicators. For this, it is necessary to also consider indicators included in the operational programme and the investment priority in which the instrument is integrated.

Inclusion of these indicators is relevant since the ex-ante evaluation report of the financial instrument must specify the expected contribution of the instrument to operational programme objectives. This will be relevant for evaluations and the performance framework of the whole program.

ESF indicators are listed in Annex 1 of regulation 1304/2013.63 In addition, as part of the operational program, the instrument will be subject to periodic evaluations.64

[63] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R1304&from=en

[64] The reference evaluation guide can be found at:
https://ec.europa.eu/sfc/en/2014/document/esf-monitoring-and-evaluation-guidance

Conclusions

This handbook offers a comprehensive outlook on financial instruments to support the social economy under the European structural and investment funds (ESIF). Its original contribution includes an analysis of the increasingly relevant role of Social Impact Investing (SII) in the European Union. This comes from the need to tackle societal challenges with financing models based on empirical evidence in public spending and from the desire to have measurable benefits for the community. The handbook also examines the relation between Social Impact Investing and the support that can be provided through the ESI funds, in particular the European Regional Development Fund (ERDF) and the European Social Fund (ESF). The document is clearly structured and mirrors current EU regulations on financial instruments. The different phases of market assessment, delivery and management, as well as measurement of results and impact, are examined in relation to the purposes of social impact instruments.

The handbook, with the support of literature and analysis of recent case studies, defines a methodology for setting up a specific instrument, i.e. a Social Impact Bond (SIB), and for establishing a Social Impact Fund (SIF - with a debt or an equity financing mechanism).

The document is intended to be a guide for anyone, particularly ESIF managing authorities, interested in implementing innovative financial instruments in the social sector, or looking to use new financing mechanisms to support social actions.

Methodological tools like definitions, checklists and examples throughout the handbook can be of immediate use for public authorities when designing and setting up financial instruments. Important themes when implementing ESIF financial instruments are quantification of the funding gap, State aid compliance, selection of intermediaries (including the choice of public procurement procedure), and reliable social impact measuring. All these and several other aspects are covered in the handbook, both from a general perspective and specifically for SIBs and SIFs. References to the latest EU regulation and the most renowned publications (e.g. OECD, EC, EIF) also reinforce the study.

The purpose of IFISE includes guidance on the use of innovative social financial instruments as provided by this handbook. Another purpose is to study the possible application of such instruments in the four EU Regions that are partners of the project: Andalusia (ES), Lombardy (IT), Piedmont (IT) and Valencian Community (ES).

With this aim, a feasibility study was developed in Lombardy on the design and implementation of a Social Impact Bond, whereas for Andalusia, Piedmont and the Valencian Community three feasibility studies were developed on the potential establishment of Social Impact Funds.

Such regional feasibility studies closely relate to the methodology described in this handbook and represent a first step towards the implementation of innovative financial instruments in the social economy in the four regions.

A summary for each regional feasibility study is available as online annex, at the following webpage: https://www.finpiemonte.it/Ifise-project

This handbook is available for download in English, Italian and Spanish version.