Harnessing social entrepreneurship and investment to bridge the social divide

By Sir Ronald Cohen

Recent protests and riots have reminded us that the gap between the haves and the have-nots has consequences that affect everybody. By bringing investment and entrepreneurial skills to bear on social problems, social entrepreneurship can have a major, beneficial impact on society. In the process, it can bring about a paradigm shift in the relationship between government, the capital markets and the social sector.

Broadly speaking, capitalism does not deal with its social consequences. Even as communities grow richer on average, so the gap between the "haves" and the "have-nots" increases. For example, since the mid-1970s, both the USA and UK have actually become less rather than more equal[1]. In the long post-war boom, many governments made significant headway in ameliorating the consequences of social inequality. This can be seen in levels of investment in areas such as health and in critical performance measures such as life expectancy. Nevertheless, governments, despite their best efforts and even in the best of times, have not been able to narrow the gap between rich and poor.

The social sector, which has traditionally been called the voluntary, non-profit or third sector, has done its best, with the support of philanthropic donations and government grants, to address the social problems that have eluded direct government intervention. In the UK, the sector comprises 200,000 organisations, 840,000 full-time-equivalent employees and over £95 billion (€111 billion) of charitable income and endowment funds[2]. The numbers seem impressive, but, when we look more closely, we find that most social sector organisations have no more than a few months of funding at their disposal. In fact, the majority of charities in the UK have annual incomes of less than £10,000 (€12,000), while larger charities, with annual income of between £1 million and £10 million (€1.17m – €11.7m) represent just 2.4% of this fragmented sector[3]. Recent evidence suggests that the number of charities in the UK is increasing even as the level of philanthropic donations and government grants decline[4].

Some argue that the social sector's problem is that it is significantly under-resourced. Others argue that the insufficiency of resources is in part a consequence of the sector's reliance upon philanthropy - from foundations and from individual donors - that can be unpredictable. (In the UK, the sector relies on donations by individuals for 37% of its income.[5]) Both critiques may be correct: the social sector has a problem in accessing capital, often because of a lack of reliable revenue streams, and, as a consequence, it is inefficient, especially in respect of building sustainable organizations, securing funding and utilizing assets to support large-scale activity.

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[1] "Growing Unequal? Income Distribution and Poverty in OECD Countries", Figure 1.2 :Trends in Income Inequality, OECD.
[2] UK Civil Society Almanac 2010, National Council of Voluntary Organisations, www.ncvo-vol.org.uk/almanac 2010
[3] Ibid.
[4] Inside Social Entrepreneurship, David Chapman and Jean Pagani, Monitor Company Group, October 2011.
[5] UK Civil Society Almanac 2010, National Council of Voluntary Organisations, www.ncvo-vol.org.uk/almanac 2010.

There have been recent moves to make the social sector more efficient by focusing on improvements to the management of both the donors and the recipients of grants. The Bill & Melinda Gates Foundation, for example, applies rigorous criteria to the assessment of the performance of organisations in receipt of its grant funding. Michael Dell's philanthropic work is similarly rigorous.

Such moves are more necessary than ever, as deficit-ridden governments now seek to pass greater responsibility onto the shoulders of the social sector. An example of this is the UK Coalition Government's strategic objective to foster the "Big Society". In essence, the Big Society agenda gives responsibility for social cohesion back to the community via the voluntary sector, and, at the same time, seeks to confer greater legitimacy upon such community work and to provide it with incentives and support. However, the social sector as currently constituted is unlikely to be able to address the scale of the social need.

This is where social entrepreneurs come in. We know that entrepreneurs create jobs and foster innovation. In that sense, they already make a substantial social contribution. But entrepreneurs have special qualities that could make a significant beneficial impact were they to be applied to social issues. The entrepreneurial mindset embraces leadership, vision, the ability to attract talented people, drive, focus, perseverance, self-confidence, optimism, competitiveness and ambition. To these one should add an appetite for taking informed risks, an unwavering focus on results, a willingness to take responsibility, a grounded sense of realism, astute judgment of opportunities and people, and expertise in the field of enterprise in question. The engagement of entrepreneurs in the social sector, bringing in their wake high expectations of performance, accountability and innovation, could lead to significantly increased social impact.

The idea of harnessing enterprise in the service of social goals is not new. Some of our great commercial enterprises were originally founded by Quaker families specifically to address social needs. This was also the motive behind, for example, the co-operative movement in Britain in the 19th Century. What we are witnessing now is a re-birth of social entrepreneurship and a new wave of social, or impact, investing informed by the experience of enterprise and venture-capital investment over the last forty years.

Could the social sector be so transformed as to allow the emergence of entrepreneurs from within its own ranks and to attract new social entrepreneurs and new capital on a large scale? The answer is yes, provided that we can create an effective system to support social entrepreneurship. This means linking the social sector to the capital markets and introducing new financial instruments that enable entrepreneurs to achieve significant social returns while also making adequate financial and fiscal returns for their investors. Given these conditions, it is possible that social entrepreneurs and impact investors will significantly fill the gap between social need and current government and social-sector provision.

In the process, charitable, institutional and private investors, attracted by the combination of social as well as financial returns and tax incentives provided by government, would bring into being a new asset class: impact investment.

This new asset class will require a specific set of investment and risk-management skills; it demands organisational structures to accommodate these skills; it must be serviced by industry organisations and associations; and it must encourage the development of standardized, social performance metrics, benchmarks and even ratings. As has been observed by the social-ventures firm Bridges Ventures in the UK, such an asset class should provide welcome diversification for capital markets: at times of economic stress, price-sensitive business models appropriate to lower income neighbourhoods can prove more resilient and can also find wider applications in the mainstream market as both margins and consumer spending power are squeezed.

Not surprisingly, politicians as well as academics, entrepreneurs and investors are paying increasingly close attention to these developments. In the USA, the UK, Canada, Israel and Australia, steps are being taken to provide social entrepreneurs with access to the same kinds of resources as business entrepreneurs. The USA's Social Innovation Fund ($173 million) and the Investing in Innovation Fund ($644 million) are notable examples, as is President Obama's allocation of $100 million to seven pilot programmes using social impact, or pay-for-success, bonds. The recent formation of Big Society Capital with £600 million of equity in the UK is another. In Canada, the Federal Government recently received the report of the Canadian Task Force on Social Finance, whose recommendations include requiring public and private foundations to devote a proportion of their funds to mission-related investments; clarifying fiduciary obligations so that pension funds and others can invest in social programmes; introducing new financial instruments for social enterprise; and marshalling government support for social enterprise, directly through seed investment and business support services and indirectly through fiscal engineering.

How likely is it that such steps will succeed? In answering this question, we would do well to consider that the global economy faced a similar moment of challenge and opportunity in the 1970s and 1980s, when many of the most familiar names in the post-war corporate world started to decline and shed jobs, among them General Motors, American Motors, Courtaulds, ICI, Smith Corona, Olivetti, US Steel, Bethlehem Steel, Kodak and International Harvester. The question then was: what would take their place?

What took their place was a new wave of business enterprise helped by venture investing, mostly focused on high-tech industries. This is the wave that brought us Intel, Cisco, Oracle, Microsoft, Apple, Sun Microsystems and Genentech. The hi-tech wave has since swept the world, taking us into the embrace of Google, Wikipedia and Facebook and ushering in a communications and information revolution based on global access to information from multiple sources. It has thereby profoundly changed global culture.

Just as hi-tech business entrepreneurs and venture capital, working in tandem, have attracted increasing numbers of talented risk-takers since the 1970s, so social enterprise and impact investment are now attracting a new generation of talented innovators seeking new approaches to achieving social returns. Entrepreneurship has acted as a flywheel for corporate performance over the last four decades. The combination of social investment and enterprise can now act as a flywheel for performance in the social sector. It can have a major influence on government policy and on the investment strategies of endowment funds, foundations, family trusts, pension funds, insurance companies and corporations. Capital flows will increase, leading organisations in the social sector will scale up and we will move the needle on social issues.

Social enterprise and impact investing, in short, look like being the wave of the future.

How will this prospect become a reality?

First, we need an enabling environment. In the 1970s and 1980s, the venture capital community argued successfully for changes in taxation and the regulation of financial institutions to foster investment in venture funds. Governments were lobbied to improve the climate for start-up and early-stage ventures. Markets to raise equity and trade stocks in pre-profit companies were introduced in the USA (Nasdaq in 1970), the UK (USM in 1979) and elsewhere in Europe (Easdaq, Euronext and the Neuer Markt in the 1990s). Rates of direct, personal taxation were reduced. And, in 1978, amendments to the USA's ERISA legislation were specifically designed to foster venture investment by US corporate pension funds.

Social enterprise and impact investment need similar rule-changes to foster investment in mission-driven ventures that deliver combined social and financial returns. We need tax incentives as well as changes in the permitted scope of activities by charitable foundations, the role of banks in low-income areas and the rules governing institutional investment. In particular, the restrictions on investment by charitable foundations and financial institutions need to be adapted to enable the inclusion of an investment allocation to social investment.

The Social Investment Task Force, which examined these issues in the UK (2000 – 2010), recommended the creation of a system to support social investment. Its specific proposals included the introduction of Community Investment Tax Relief, fashioned after the US's New Markets Tax Credits; the formation of community development venture funds to take a long-term view of equity investment in poorer, underinvested areas; greater disclosure of the lending behaviour of banks in low-income areas to encourage best practice; greater latitude and encouragement for charitable trusts and foundations to invest in community development initiatives; and the strengthening of the community development finance industry through the creation of a professional association.

These recommendations were taken up by the UK's Labour Government and the decade to 2010 witnessed the emergence or development of many social enterprises, including Charity Bank, CAF Venturesome, Big Issue Invest, Breakthrough, Investing for Good, CAN, Impetus Trust, Bridges Ventures, Social Finance and Social Investment Business. We need to continue this momentum by focusing government's attention on building the enabling environment to support impact investing.

Next, there needs to be a social investment bank that acts as a wholesaler of capital to channel funds into the social sector, which has, to date, been disconnected almost completely from capital markets and so has suffered from inefficiency in funding and capital formation. Social returns do not attract capital in the way that financial returns do. An organization is required to act as a financial engine for the social sector, attracting capital by blending social returns with financial returns and tax incentives.

In the UK, the Commission on Unclaimed Assets (CUA) and the Social Investment Task Force forcefully argued for the creation of this "social investment bank," capitalized from the pool of unclaimed assets languishing for more than fifteen years in UK commercial bank accounts and building societies. This proposal was endorsed by both the last Labour Government and the present Coalition Government, which supported in July 2011 the formation of Big Society Capital, with £200 million (€234m) of equity from commercial banks and £400 million (€468m) from the pool of unclaimed assets.

A crucial role for Big Society Capital is to devise and support the development of new instruments for social investment. Social Finance, Ltd., a front-line social investment bank which grew out of the work of the CUA and the recommendations of the Social Investment Task Force, created the Social Impact Bond (SiB), an innovative financial instrument currently in use with the UK Ministry of Justice to reduce recidivism by prisoners released from Peterborough jail. SiB's provide a new mechanism for payment by results, whereby investors fund not-for-profit social ventures whose intervention results in a social benefit as well as financial savings to the government. A social venture that reduces very high reoffending rates, for example, would save money by reducing the prison population and the cost of the justice system in addition to providing future tax revenues from employment.

The financial return on investment in an SiB varies directly according to the social benefit achieved. The Peterborough SiB, issued in September 2010, will pay investors a sliding yield, starting at 2.5% and rising to a capped annual return of 13.3%, but only if reoffending is reduced by at least 7.5%. If reoffending is reduced by anything less than this benchmark, the government pays nothing and investors lose their principal. Even at the highest rate of 13.3%, to achieve which the reoffending rate has to be cut by at least 15%, the government is forecast to pay out only about one-third of its estimated cost savings.

SiB's provide long-term, upfront capital to not-for-profits, which do not bear any financial risk and benefit from predictable working capital over the life of the bond. SiB's are likely to work best when applied to clearly defined target groups, where there are effective not-for-profits already active, with interventions that are clearly understood and whose impact can be measured. The incentive to use SiB's exists wherever the cost of intervention is significantly less than the public-sector savings they deliver. In addition to targeting recidivism, social interventions that SiB's could finance include those that lower the drop-out rate in schools, increase rehabilitation rates from drug dependency, reduce homelessness, enable the elderly to live at home rather than a state-run facility, and decrease the number of children in the child welfare system.

The SiB appears to be the first financial instrument that enables social entrepreneurs and investors to read across from social returns to financial returns and so to raise capital based on social outcomes. Already it has attracted attention in the USA, where Social Finance has established a sister organization, Social Finance, Inc., based in Boston. Social Finance, Inc. is hoping to bring SiB's to the US market in 2012. It is currently engaged in detailed discussions with Massachusetts, New York City and other local authorities, and is pursuing applications in areas such as criminal justice and housing. At the same time, President Obama recently announced that his administration is to set aside $100 million for seven pilot programmes using social impact, or pay-for-success, bonds. Similarly, Social Finance Israel is currently being established as a sister company of Social Finance Ltd. and Social Finance USA, and one of its first initiatives will be the issuance of SiB's. While significant opportunity surrounds this new instrument, it is already clear that it is just the precursor of other impact-investing financial securities that will be developed to help build the industry.

These innovations are already changing the mindset of the social sector, which is now embracing output-based and market-based solutions that, for example, enable foundations to use their balance sheets to achieve social aims, rather than simply funding grants out of revenue. We are beginning to move away from the situation where,

> "most non-profits attempt to keep their administrative expenses low and focus narrowly on short-term financial performance. As a result, they fail to build capabilities in strategy, leadership, fund-raising, performance measurement, and organizational development"[6].

The unsatisfactory state of affairs described above has sometimes been imposed by philanthropic funding that requires money to reach beneficiaries in the most direct way possible and precludes the structured, long-term commitments necessary to build and finance growing organizations.

It is very significant that when Social Finance raised the first SiB of £5 million from charitable foundations and others, most of these investors, rather than treating the money as a grant, held it on their balance sheets as an investment. This demonstrates the interest of some thought-leading foundation trustees in bringing charitable assets to support the development of the social sector alongside grants.

Of course, achieving the transformation advocated here will be challenging. Social entrepreneurs manage two bottom lines, one social and one financial (and often three if they target environmental issues as well). This requires special skills, which, in turn, suggests the need for special training and experience. For example, Social Finance, which brought the first SiB, provides in-house expertise in recidivism to support the specialist not-for-profits that will deliver the proposed interventions with released prisoners. This is akin to the way a venture capital or private equity firm would help an investee company. It is crucial, for it gives investors confidence that the right blend of social and financial returns will be delivered over time.

Social enterprise will never render obsolete either philanthropy or government programmes. But social enterprise and impact investment could dramatically change the role of the social sector in the way that venture capital and business entrepreneurship did in mainstream business in the 1980s and 1990s. As *The Economist* recently noted, the idea is "to transform the way public services are provided, by tapping the ingenuity of people in the private sector, especially social entrepreneurs"[7].

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[6] Kaplan, Robert, and Grossman, Allen , Harvard Business Review, 2010.

[7] The Economist, "Let's Hear Those Ideas" August 12, 2010.

All new investment products begin without a track record and with a very limited pool of available capital. They have to create their own market. In recent years, venture capital, private equity and hedge funds – and, more recently, micro-finance – have successfully been built from lowly beginnings into significant new asset classes in a relatively short time. Now, a new generation of entrepreneurs is coming forward eager to make a social impact. With the support of government, the philanthropic sector and the capital markets, these social entrepreneurs will usher in new, powerful ways of dealing with social issues that will help maintain the cohesion of society and improve the economy.

As social enterprise achieves significant scale, it will transform the social sector and lead to a new balance between the roles of government, the capital markets and citizens. It will contribute to a paradigm shift whereby there is no longer a clear binary choice between making money and doing good. In the future, corporations, institutional investors, private investors, mutual funds and philanthropic donors will all be engaged, to some degree, in social enterprise and impact investing.

What entrepreneurship has done for our economies in recent years, social entrepreneurship must now do for society.