Selecting the most appropriate funding arrangements for UK SIBs in response to Covid-19

This note is directed towards all SIB stakeholders in the UK as they think through the implications of COVID19 on their contracts.

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What should be considered?

Over the past few weeks, we have been listening to the concerns and considerations of various parties to impact bond projects (social outcome contracts with independent investors). We have convened four Emergency Responses and Government Outcomes peer learning sessions, and spoken to a wide network of people involved in the design and delivery of impact bond project worldwide. Many of the insights we have gathered are available on our Covid-19 resource hub.

Naturally, the immediate concern for projects was to ensure they continued to meet the needs of service users (existing and new), which has meant overcoming an array of operational challenges, given social distancing restrictions. Attention is now turning to the contracts themselves.

We have determined that project stakeholders have six alternative contract-management responses to the crisis, which we lay out here. Each depends on the particular circumstances of the case, and there will be nuances we do not capture, as well as room for 'hybrid' approaches that borrow from multiple alternatives. Ultimately is up to outcome payers to decide on the best course of action, in discussion and negotiation with providers and investors. The importance of strong relationships and a collaborative approach has been repeatedly emphasised by project stakeholders.

The UK's top-up funds for locally-commissioned SIBs – Life Chances Fund and Commissioning Better Outcomes Fund – have indicated there will be some flexibility in how payments operate during the period of Covid-19 (with temporary alternative payment arrangements to September 2020 offered in the first instance). Both have signaled willingness to explore extensions to their Funds, but for LCF applicants this is not yet known and decisions should be made now on the basis that the LCF will run to its existing timetable. Other central-government commissioned SIBs are similarly taking action to support projects: MHCLG are relaxing their reporting criteria and DfE have relaxed payment terms.

Why might impact bonds need special consideration?

The UK Government has advised a temporary move away from payment-by-results (PbR) during the COVID19 crisis in the expectation that the unprecedented disruption will often make it very hard to achieve results and claim payment, exposing providers to potentially unsustainable risks. However, impact bonds are a somewhat unique case, as the risk of non-payment is usually explicitly carried by, or at least shared by, independent third-party investors. Any adjustments to the operational environment or to the contract terms are therefore likely to have direct implications for these investors, as well as, or potentially instead of, providers.

The three considerations below may be true of many PbR-like contracts, and may be especially true for SIBs due to these unique risk-sharing arrangements:

1. Additional working capital may already be available from third-party investors to maintain providers' operations (for example, data from the Commissioning Better Outcomes Fund indicates many projects have not yet drawn on all the capital originally committed);
2. Third-party investors may be willing to tolerate or underwrite any increased risk in projects due to Covid-19 if payment terms can be adjusted to accommodate this;
3. If payment moves away from outcomes, towards fee-for-service or grant-based payment, investors' projected returns in any given project may be adversely or advantageously affected, depending on how the new arrangement is configured.

In this note we often make reference to "investors and / or providers " or "the investor-provider partnership", to acknowledge that in both locally and centrally commissioned SIBs, they often work with commissioners as a single contractual unit (sometimes referred to as a 'Special Purpose Vehicle' or 'Prime').

Six alternative contract-management responses

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1	2	3	4	5	6
No contract alteration	Adjust outcome payment terms	Temporary switch to fee-for-service or grant	Pause delivery	Permanent switch to fee-for-service or grant	Terminate the contract

Increasing departure from original project intention →

1

No contract alteration

Why do this?

For this to work, all of the below need to apply:

- The type of needs that the contract were intended to address have not fundamentally changed
- Any increase in demand / referrals can be accommodated by the payment mechanism as it is
- The service can adequately adapt to social distancing measures (e.g. by going online) without a significant dip in quality (in the case of licensed interventions, this would need to be approved by the licensor)
- Payable outputs and outcomes can still be measured despite social distancing measures (including a live comparison group, if there is one)

What it means for…

- *Commissioners*. If increased demand is expected, this will need to be budgeted for.
- *Investors*. If circumstances support this course of action, the risk profile for investors will not fundamentally change.
- *Providers*. Providers will need to find ways to maintain service delivery despite social distancing measures.
- *Top-up funders*. Top-up funders can continue to support the contract structures in the same way.

Things to consider before you decide

- Circumstances might still change. The decision to continue under the same terms should be kept under review.

2

Adjust outcome payment terms

Why do this?

One or more of the below apply:

- The type of needs that the contract was intended to address have changed considerably
- An unprecedented decrease in demand / referrals is expected, increasing contract risk for the investor-provider partnership
- Social distancing measures (e.g. the service going online) are expected to affect service quality and make it harder to achieve outcomes, increasing risk for the investor-provider partnership

And:

- Payable outputs and outcomes can still be measured despite social distancing measures (including a live comparison group, if there is one)

What it means for…

- *Commissioners*. Changes to demand could be accommodated by a re-profiling of the projected future payments. A manifest change in type or level of need, or operational challenges which make it much harder to achieve outcomes, may mean you need to re-negotiate payment terms with the investor-provider partnership. In this case, you may need to rely on contract variation / force majeure clauses to make the changes legally sound. You will need to be convinced that either: (a) cohort needs have changed and outcomes need to be defined differently / new outcomes need to be defined, OR (b) it is now considerably harder to achieve outcomes, and therefore that costs and / or risks to the provider and / or investor have increased considerably. In the latter case, it may be that more should be paid for outcomes achieved; if budgets cannot accommodate higher maximum payment, then any increase in payment per outcome could be compensated by decreasing the expected volume of referrals over the contract lifetime, so that the maximum total payment stays the same.
- *Investors*. If you perceive an increased risk to your capital due to changing cohort needs or new operational challenges, you will need to make the case that commissioners should compensate for this should the project still meet its targeted outcomes.
- *Providers*. You should feel able to continue to respond to the changed needs that your users are facing due to the emergency, with costs and risks covered by investors and / or commissioners. You will need to be highly transparent about changing needs and operational challenges, and the implications of these.
- *Top-up funders*. Some have indicated they will listen to other key stakeholders (particularly local commissioners and providers) and join in negotiations on formulating the new terms. A hybrid arrangement which mixes outcome-based payment with fee-for-service may be considered.

Things to consider before you decide

- It can be time-consuming and laborious to re-forecast referral rates and likely outcome achievement, especially in an uncertain environment like this. This re-negotiation will cost money for all parties. Commissioners should take this into consideration.
- Do you expect the change to be permanent, or might you make it time-bound, and subject to a review period? When services return to normal (face-to-face), demand increases once again, or the type of need changes back to how it was, it may no longer be appropriate to pay on the new terms (at least for new service users).

3

Temporary switch to fee-for service or grant

Why do this?

One or more of the below need to apply:

- Temporary, emergency relief is needed for investors / providers while new operational or contractual measures are put in place
- Payable outputs and outcomes cannot be measured for as long as social distancing measures remain in place, e.g. because a physical assessment needs to be undertaken
- Commissioners feel it is inappropriate to continue on payment-for-outcomes basis at the present time

And

- The service can continue as it can adequately adapt to social distancing measures (e.g. by going online)

What it means for…

- *Commissioners*. A new basis for payments needs to be worked out for the duration of social distancing / service disruption. Either you will need to draw a service specification describing the service desired, or provide payment on a grant basis and trust the provider to provide the services expected. To minimise the disruption to the contract and make it as straightforward as possible to resume it in the future, you should consider continuing to call in reports on outcomes achieved wherever possible, even though these are no longer the basis for payment. The payment amount should be based on the original projections for payments during this period. As this will have been based on a range of scenarios, this will mean basing payment on whichever scenario you believe provides sufficient payment to enable the providers to deliver what is required.
- *Investors*. Your capital will not carry risk for as long as the new fee-for-service or grant-based payments are in place. This will alter the repayment profile of the investment, and capital return expectations.
- *Providers*. You should continue to adapt delivery to the circumstances and keep operations as as close as you can to those required by the outcomes contract, in the expectation that this will resume once disruption ends.
- *Top-up funders* have indicated that they will continue to expect measurement of outcomes and collection and sharing of data for learning where possible. Some may consider whether to join local commissioners in the temporary switch, or to continue to make their payments on an outcome basis.

Things to consider before you decide

- You should agree in advance how the project will be moved back to an outcomes-basis, when that will occur, and what support needs to be put in place to facilitate it. Given the fast-changing circumstances, any agreement can be made subject to review.
- You should consider how future outcomes payments are accounted for if they arise from activity during the grant / fee for service payment period.
- You could consider whether to split the cohort into those who can no longer be paid under the original terms, and those who can.
- You should continue to collect and report evidence of outcomes achievement throughout the period of fee-for-service / grant-based payment wherever possible.

4

Pause delivery

Why do this?

One or more of the below need to apply:

- The service cannot adapt to social distancing measures (e.g. it cannot be provided online)
- Demand for the service has dropped severely or disappeared, but is expected to rebound when social distancing measures are lifted
- The SIB was ready to launch, but Covid-19 has made this impractical

What it means for…

- *Commissioners*. Where possible, extend the duration of the SIB so that there is still enough time for outcomes to be achieved when services resume. Continue to require measurement of outcomes so that the ‘baseline’ for the cohort (and any comparison group) can be adjusted when the service resumes.
- *Investors*. Providers may need to rely on your capital to keep the necessary project infrastructure in place until services resume. This will extend capital repayment periods.
- *Providers*. You will need to make use of the government’s furlough scheme so as to keep your staff in place. You may require additional emergency finance to be able to maintain project infrastructure until services can resume. Some social investment institutions and charitable foundations have offered such funding.
- *Top-up funders* have indicated they will work with other project stakeholders to agree an appropriate length of time to pause.

Things to consider before you decide

- When services resume, the world will be different. Demand may be much higher or much lower, or the circumstances of service delivery may have changed. You may still need to consider alternative 2 – adjust outcome payment terms – or even 5 – a permanent switch to fee-for-service or grant.

5

Permanent switch to fee-for service or grant

Why do this?

One or more of the below need to apply:

- The original business case for the SIB is no longer valid, for example because payments were to be made from cashable savings but those savings are no longer expected (or can no longer be 'cashed')
- The cost and / or risk to the investor / provider has increased as in Alternative 2, BUT the capital committed by investors is not enough to keep services running while a new basis on which to pay for services / outcomes is negotiated OR the investors are unwilling to tolerate the increased risk during this period

And

- The service is still required and can adequately adapt to social distancing measures (e.g. by going online)

What it means for…

- *Commissioners*. A new basis for payments needs to be worked out (see alternative 3). You should negotiate the amount to be paid based on service cost or an 'open book accounting' basis, rather than an outcomes-costing methodology. Providers will no longer need up-front working capital if payment switches to up-front or near-term, and investors / providers will not carry the risk of non-payment under such payment terms. Consequently, you should not expect to pay the premium that might be expected for this in impact bond mechanisms. You will need to consider if the switch of payment terms can be accommodated within the contract variation / force majeure clause. If not, you may need to terminate the contract and re-let it on the new basis, which would require you to compensate investors who will no longer be able to recoup their up-front capital through the impact bond mechanism.
- *Investors*. Your capital will not carry the same risk under a fee-for-service or grant-based payment. Additionally, providers' working capital needs will be alleviated by the switch to up-front or near-term payment. This will alter the repayment profile of the investment (and possibly the basis of its repayment as well), and both providers and commissioners may no longer expect to cover the cost of return expectations as originally scoped.
- *Providers*. You should consider whether the operational implications of delivering under a payment-by-results contract, and the value of partnering with an investor, can still be usefully applied under the new contract terms.
- *Top-up funders* have indicated that they would be unlikely to continue to support projects undertaking a permanent move away from the originally agreed impact bond model (or failing to move back to this after an agreed temporary period). Some have indicated they may support a switch other innovative forms of outcomes-oriented commissioning.

Things to consider before you decide

- All project stakeholders should take care not to end up in this position by accident, for example if it turns out to be too difficult to move back to outcome-based payment after a temporary switch to grant / fee for service. This danger can be alleviated by agreeing in advance when and how temporary measures will end.
- If a permanent switch is intended, there should be a strong justification from all parties as to why the new funding model is better suited to the world after Covid-19.
- Is it useful to continue to expect outcomes to be measured as before?

6

Terminate the contract

Why do this?

One or more of the below need to apply:

- The service cannot adapt to social distancing measures (e.g. it cannot be provided online) and staff and project infrastructure cannot be kept in place
- Demand for the service has dropped severely or disappeared, and is not expected to rebound
- The service cannot be re-oriented to a new cohort or new set of needs

What it means for…

- *Commissioners*. Force majeure clauses may be used to excuse the provider / investor from contract performance if all alternatives have been explored. There may be ambiguity on whether the invocation of force majeure would require you to compensate investors who will no longer be able to recoup their up-front capital.
- *Investors*. You will need to negotiate the reimbursement of any upfront capital not yet repaid.
- *Providers*. You will need to re-allocate or lay off staff, which may have HR implications.
- *Top-up funders* have indicated that they will liaise with local commissioners and may consider whether providers should be supported to protect their organisational resilience / viability (subject to programmes' governance and remit).

Things to consider before you decide

- This should be a last resort as it unlikely to be a desirable result for any party. This course of action will imply considerable financial loss for providers and their staff, and investors. Can the service be re-oriented towards new needs caused by Covid-19 instead?