Steve Rothschild, Founder & Chair of Twin Cities RISE!

Civic Caucus, 8301 Creekside Circle, Bloomington, MN 55437

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Summary of meeting: Human Capital Performance Bonds are a way for private investors to finance social service providers (mostly nonprofit organizations) able to demonstrate economic value that is above the state's cost of borrowing the funds. Economic value is a combination of incremental cash to the state from taxes paid and lower public subsidies realized as a result of the providers' social value creation. The state pays a portion of this cash to the successful provider, and interest to investors. A proposal to pilot this program-in part already shown to work with one Minnesota nonprofit-is making its way through the legislature this session.

A. Welcome and introductions - Steve Rothschild is the Founder and Chairman of the Board of Twin Cities RISE! (TCR!), an organization that provides employers with skilled workers, primarily men from communities of color in the Twin Cities area, by training under- and unemployed adults for skilled jobs that pay a living wage.

In November 2010, Rothschild founded Invest in Outcomes (IIO), where he is president. IIO is a non-profit organization whose purpose it is to pilot a "Human Capital Performance Bond", an innovative financing vehicle to both improve the productivity of state human service spending and attract private investment capital for high performing non-profits.

Formerly, Rothschild was CEO of TCR! during its first nine years. He was also formerly an Executive Vice President of General Mills, Inc.

B. Comments and discussion -

Only the private sector has the capacity to resolve the state's structural problems

Rothschild presented projections derived by state economist Tom Stinson' s office showing that if state revenue increases at an anticipated 3.9 percent, health care spending increases at its projected 8.5 percent and education spending growth is held even with inflation at 2 percent, then all other spending, including such things as higher education, early childhood education, jobs programs, and infrastructure, must decrease 3.9 percent. The result is a compounding decrease in spending in all other areas of public services statewide.

"I would submit to you," Rothschild said, "we will never see General Fund spending for these items at $6 billion again, unless something fundamental changes in the way the state funds service providers.

"The state created this problem," Rothschild said. "Philanthropy cannot resolve it-that would require the equivalent of four new United Ways each year." He believes the only way to resolve this funding shortfall is to attract the private sector. Private, market rate investors have the capacity to inject significant capital but they have traditionally not invested in social service endeavors.

The state is spending money without knowing what it gets in return

There are three assumptions underlying Rothschild's formation of the Human Capital Performance Bonds plan:

Assumption 1: Quality nonprofits create social value

Assumption 2: Social value equates to economic value (the value can be monetized)

Assumption 3: Economic value equates to cash flow

"You can monetize the economic value of most social programs, if they avoid costs and increase revenues to the state,"

"The state now is spending money without knowing what it gets in return because it doesn't measure outcomes, it doesn't capture value and it doesn't reward high performance based on value being created." Measuring economic impact would allow us to determine which programs create the most social value.

Original "pay for performance" with Twin Cities RISE! (TCR!)

A 'pay for performance' contract with TCR! was established by the Minnesota legislature in 1997. State officials estimated cash flow to the state based on the economic value of higher tax receipts and lower government subsidies resulting from increased incomes to individuals attaining better jobs. TCR! is paid only for success, when an individual's income increases by at least $10,000 as they obtain and stay in the job for at least one year. TCR! shares the economic value that it creates for the state and takes all the risks; there is no payment for failure.

Over the last 13 years the state has received $7.24 for each $1 it has invested or a $33.4million benefit for a $4.6million investment.

Human Capital Performance Bonds

Human Capital Performance Bonds (HCPBs) build on pay for performance as follows:

- The state sells bonds with an (anticipated) AA-rating to external investors.

- The bond proceeds go into a "performance pool" segregated from the state budget and overseen by a board of upstanding citizens with demonstrated financial expertise who are appointed by the Commissioner of The Office of Management and Budget.

- Any entity providing service to the state at present-non-profit, for-profit, union, etc.-could apply to receive funding from the performance pool.

- The applicant would provide performance data on its outcomes, and a group of economists would evaluate (1) the applicant's ability to have its outcomes monetized, and (2) whether returns are sufficiently high to cover the costs of borrowing (the interest rate on the HCPBs). The economists would also judge whether an organization's track record would imply future success.

"This allows a program to participate," Rothschild said, about the qualification process. It's the way for the state to ensure that only organizations with a high likelihood of yielding a sufficient return for the state and, hence sufficient cash flow to repay investors, are involved in the pool.

-The pool pays sums to the participating organization only as long as performance standards are met.

-The bond would be structured to pay up to 75% more than the pool of providers' current state allocation over 3-4 years (assuming a 10 year bond). This provides significant new investment potential for participating providers if their outcomes meet established targets.

- If performance goals are met, the state's improved cash flow funds the bonds' principal and interest payments.

- If performance goals are not met, the state has use of the funds to retire the bond early.

The costs of failure to the state (some interest and administrative expense) are more than offset by the potential of tens of millions of dollars in new investment if it is successful.

Sample scenario

Rothschild shared an example of how the performance bonds would work in a pilot program: When a workforce program trains a client and places that person in a higher paying job, the change in income creates increases in income and sales taxes, as well as savings to the departments of Health and Human Services, Corrections, Employment and Economic Development, and other areas of government services. The present value of this benefit is divided between interest and principal repayment to the investor and a performance payment to the program provider. Greater benefits generate larger performance payments.

"The state must track program clients by their Social Security numbers and be able to determine the actual changes in their tax payments and any government subsidy. Obtaining actual results is critical to the fidelity of the bond structure.

The 2011 session

"We have a bill in the House authored by Keith Downey and in the Senate by Julie Rosen. There is broad support by leadership in both the Senate and House.

"As this idea moves forward I think there will be more interest. It can be a catalyst for redesign, because it has the potential to stimulate government officials, philanthropists, investors and providers to think differently about meaningful outcomes and value generation."

A participant asked where friction on the bill might come from? "From the complexity, the limited exposure of the legislature to such ideas and the present focus on the deficit"

Questions from participants

Q: How could this scheme work for organizations like homeless shelters?

A: The basic question to ask is: What is the social outcome, and can it be monetized? To what extent does it increase state revenues, and to what extent does it avoid state costs? The key here is the fidelity of the economics. If you can't capture the economics then it doesn't work. The discipline of this is that the savings must be captured, and the savings on the pool must be sufficient to cover costs while returning interest to investors.

Q: What are the non-monetary benefits?

A: This program will provide an incentive for organizations to improve results. The highest performers that are most effective and efficient will garner more investment and scale up their programs to serve more needy clients. Some that are close-doing well but not good enough-will have a target to aim for to get better. There will be greater transparency of outcomes to state officials, legislators and taxpayers, alike.

Q: Why keep the program separate from the legislature, and privately capitalized?

A: The sale of bonds, the payment of interest and repayment of principal will need legislative approval. However, the legislative process is not set up to evaluate purely economic outcomes necessary to ensure the fidelity of the bond (e.g. short term decision making, spending and revenue are handled by different committees and political pressures include non-economic criteria). Furthermore, the state is cutting budgets, not increasing them. Private investment is the only legitimate way to meaningfully increase support for worthy social programs that demonstrate value.

Q: What kind of organizations would be interested?

A: Any organization that can provide the data to demonstrate their economic value from their social outcomes.

Q: What areas of service do you see participating in the first stages of a pilot?

A: Potentially work force development, rapid housing, senior care, disabilities, among others. The economists are looking into areas of state government where potential cost avoidance is great in the near term. Over time, we will look across all state government spending areas and data-mine to find areas of potential.

Q: What are other potential service providers that will *not* be part of the initial pilot program?

A: It won't work where social value doesn't equate to economic value like in a museum or zoo. Areas where it will take more time to evaluate data, where the return takes longer to develop or where other considerations could delay implementation won't initially be included. Examples include K-12 education, health care, early childhood education, and higher ed. Down the road these could be excellent candidates given the potential for cost avoidance and increased revenue.

Q: Could bonds be issued locally?

A: We need the state to issue the bond during the pilot because investors have no way of assessing its risk as a new investment. Once the bond is established a group representing providers could issue the bond itself, necessitating only a contract with the state to pay the group based on a share of the economic value it creates. The group would pay the investors directly. It's also possible that counties could issue bonds once value to them is established and captured. The federal government is another logical arena.

C. Closing -

To close Rothschild highlighted differences between this model and other social venture investments

Individuals, institutions and foundations are increasingly making Social Capital Investments. They are invested in a variety of social areas and expect to earn *less* than a market rate of return for the investor.

While HCPB's have a similar purpose- to provide increased investment to high performing social organizations- it differs in a number of important ways: first, it is a *market rate investment* thereby attracting a much larger potential investment pool including commercial banks and other financial institutions; second, as a bond whose interest rate will be around 4% the hurdle rate is much lower than social venture capital that requires 3 to 4 times the return to attract even social investors. As such, HCPB's, if successful, could scale up to much larger investment pools both in Minnesota and elsewhere.

"We see HCPB's improving the productivity of state spending while providing a major new source of funds for high performing service providers. While traditional state spending for social services will be squeezed in the years ahead, HCPB's offer a way to increase social spending as productivity is improved."

Rothschild promised to keep the Civic Caucus abreast as the plan makes its way through the legislative process.