THE FUTURE FOR CHILDREN BOND

Identifying the lessons learned from Allia's bond offer to retail investors

Abigail Rotheroe, Plum Lomax, Iona Joy
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INTRODUCTION
TIM JONES, CHIEF EXECUTIVE, ALLIA

In the context of cuts to public funding and strains on philanthropic giving, set against the persistence and growth of social needs, there is increasing interest in new models of service delivery and financing to address our most challenging social problems. The concept of payment-by-results has captured the imagination of policy makers, seeming to offer the public sector a risk free way to harness private capital to fund innovation in service delivery and only paying out if the programme succeeds in delivering outcomes: thereby, so the theory goes, creating overall savings to the public purse.

To date, such models have predominantly been funded by a core group of institutional investors with a dedicated social mission, and a small number of other foundations and sophisticated high net worth individuals. These investors naturally represent a limited pool of capital and, if further outcomes-based models are to be developed, then further sources of capital will have to be found.

This is the challenge that Allia explored through the Future for Children Bond. With the support of Big Lottery Fund, we tested the question of whether funding for complex social investment products could be raised through a public offer to individual investors if they could be confident of getting their money back and were taking risk only on the level of return they received in order to make a social impact.

The answer we found was that, in a market that so far has very little awareness or experience of social investments, engaging with retail investors while at the same time protecting them from making inappropriate investments is extremely difficult. We saw substantial interest from many investors and intermediaries but found real barriers to effective distribution and capital raising. Investors were required to apply for the Future for Children Bond through a financial adviser in order to ensure that they understood the product and that it would be appropriate for them. We found that advisers generally feel ill-equipped to understand and promote social investment products and find it hard to justify the costs of due diligence. While there is evidence that a number of retail investors want to try social investing it is difficult for people to make small investments in complex products when they now have to factor in the cost of financial advice and difficult, too, for product providers to allow small investments while at the same time screening out inexperienced, unsuitable investors.

Allia’s findings show that specific support from the Financial Conduct Authority might help the social investment market for retail investors to grow. For instance, advisers seek greater clarity on regulation and for guidance on best practice to help them feel comfortable with the process of advising clients on the appropriateness of social investments. There is an inefficiency and market failure in a system where each advisory firm has to conduct its own due diligence, notwithstanding it may have only a small number of relevant clients and may therefore be unable to recoup its costs. We propose that advisers should be able to rely on independent due diligence conducted by experts in social investment with the approval of the FCA. Finally, for prospective investors who do not have a financial adviser, or do not wish to pay for advice, we would propose that the FCA should work with social investment product providers to develop appropriate investor self-assessment so that such investors can independently check, and affirm to the product provider, that they understand the nature of the offer and consider it suitable for them.

Our experience suggests a note of caution to policy makers and developers of social investment structures. Though Allia remains positive about the potential of social impact bonds and other outcome-based models to tackle entrenched needs, we believe it necessary to consider not only how to meet needs now but also how to build the social investment market as a whole. To take a business analogy, it is good for companies to invest in

R&D to develop and test new concepts but both the product and the market demand have to be sufficiently developed before going into mass production and distribution: the fact that social impact models can be created doesn't necessarily mean they are ready for rolling out. Social investment R&D is vital, but the sector's core focus may, for a while yet, need to be on the creation of simple, market-ready products. They may have less glamorous social impact but will start to develop distribution channels and build market behaviours for using capital for social good. If we can in this way create a real and tangible social investment market at scale, then by the time that social impact bonds have gained their track record mainstream investment markets may be ready to buy them.

SUMMARY OF FINDINGS

Significant attention has been paid to social impact bonds from within government, the voluntary sector and the wider public since the launch of the Peterborough bond in 2010. However, there is a concern that at present, there is only a limited number of investors prepared to supply the required capital for future bonds, dominated by a small number of trusts & foundations and individual investors. How can the social investment market, and social impact bonds in particular, appeal to a much wider group of investors?

Allia attempted to answer this by developing the Future for Children (FfC) bond to test the retail market's appetite for investing in a social impact bond. The bond offered investors the protection of their initial capital, with a chance of an additional variable return subject to the success of a social impact bond, structured around a social programme to help children on the edge of care. It was devised in such a way that the original social impact bond to which the FfC bond was linked would in no way be affected by the success or failure of the FfC bond. Product testing is a recognised part of a developing market and Allia and its partners should be commended for their time and resources dedicated to putting into practice a concept that had previously only been discussed on paper.

In the event, Allia decided not to go ahead with issuing the bond as the level of subscriptions were below the amount needed for cost effective management of the bond. In the process of marketing the bond, Allia generated some very positive media coverage, has helped improve the financial adviser market's knowledge of social investment, and above all has created valuable lessons for the sector as a whole.

This evaluation of the bond highlights several challenges faced by Allia, from a marketing, adviser and product perspective. It is not possible to attribute the low level of take up for the bond to one particular aspect but this report features two groups of findings:

- findings specific to the product and the process, which can be addressed by future product providers; and
- findings that rely on market and regulatory development and are therefore outside the control of product providers, but which should be taken into account regarding future product design. These findings are also useful for policy makers attempting to grow the retail market.

We have summarised the challenges faced by the bond offer in the table below, all of which are explained in more detail in subsequent pages, assessed if they are fixable and suggested some possible solutions.

	Challenges	Fixable?	Solutions
Marketing the bond	Advisers found the bond offer period too short	Yes	Future products are unlikely to have this constraint.
	Low levels of knowledge across market on social investment	Yes	Consistent with the early stage of the market's development. This should improve with time and investment opportunities.
	Difficulty in raising demand from retail investors	Unclear	Demand by retail investors for social investment products should improve as advisers become more familiar with social investment and they explore interest with their clients.
	Distribution channels not yet established	Yes	Product providers need to build relationships with intermediaries. Channels will become more established over time with increasing numbers of products.
Upfront issues for advisers	Recognition of Allia low	Yes	Familiarity with product providers will increase over time.
	Timing of the offer during an uncertain and busy period for advisers	Yes	One-off external factors unlikely to recur again (eg, introduction of RDR). Future offers should avoid end of tax year.
	Regulation on social investment just starting to emerge and presents barriers	Probable	There is some evidence that the regulator is engaged with social investment but increased regulatory clarity is still needed.
	Cost of advising on social investment is high for advisers	Yes	Familiar and simple social investment products, and regulatory clarity, are required to reduce the cost of advising on social investment for advisers.
Bond features	Advisers found the bond structure too complex	Yes	Familiar and simple social investment products required, particularly during the nascent stage of the market's development. More training and CPD opportunities for advisers are required.
	Investor protection measures (advised product and level of minimum investment) potentially an obstacle	Unclear	Allia's need to protect itself and the bond investors transferred the risk to financial advisers. Advisers will need more regulatory clarity on suitability before advising on social investment.
	Restrictions over transparency of bond returns	Yes	Social investment products require the same standards of transparency about returns as financial products.
	Difficulty understanding the risks of the bond	Yes	Familiar and simple social investment products are required until more track record developed for more complex structures.
	Term too long for illiquid product	Yes	Reduce terms of products.
	Impact of inflation on returns	Yes	Reduce term of capital protected products or limit proportion of capital protection in products.
	Diversified products preferred	Yes	Pooled vehicles are preferred but only possible when sufficient investment opportunities exist. This should be possible over time.
	No tax relief available	Possible	The government should consider this in its current consultation on social investment tax relief.

ABOUT THIS REPORT

NPC was asked by Allia to produce an independent evaluation of the Future for Children Bond (FfC bond). The development of the FfC bond and this evaluation have been funded by the Big Lottery Fund's Next Steps programme.

The FfC bond represented the first public offer to invest in a social impact bond.

In this report, we describe the structure of the bond and the marketing strategy that surrounded its launch, and then examine the challenges that have arisen in bringing the bond to market. From this, we discuss the lessons to be learnt from the offer, and recommend how these might inform future practice in developing retail social investment products in accordance with the objectives of the Big Lottery Fund's Next Steps programme. It is worth mentioning that this report is not an evaluation of the social investment market itself, but that it does take into account the stage of development of the market over the launch and offer period.

Our research draws on interviews with Allia, and other partners involved with the bond, four financial advisers, and two of the investors who put in applications for the deal. The interviews were carried out before the launch, during the offer period and after the offer closed. They were semi-structured to allow interviewees to introduce areas for discussion that they deemed relevant. The report also references recent research into this area.

Structure

The report is split into three sections:

- Background to the offer
  - The Future for Children Bond
  - The social investment market
  - The marketing strategy
- Challenges and lessons learnt
  - Marketing the bond
  - Upfront issues for financial advisers
  - Bond features
- Conclusions

BACKGROUND

The Future for Children Bond

Opportunity

Allia, with support from the Big Lottery Fund through its Next Steps programme, developed the Future for Children Bond (FfC bond) as the first opportunity for the public to invest in a ‘social impact bond’ (SIB). A SIB is an investment model based upon a contract with a public sector commissioner to pay agreed amounts according to the social outcomes achieved. The return on an investment in a SIB therefore depends on the success of the intervention in delivering outcomes, and the investment may not be returned in full or at all if outcomes are lower than expected. To date, investing directly in social impact bonds has mostly been restricted to a small number of sophisticated institutional investors.

The FfC bond was a pilot designed to test the opportunities for attracting new sources of capital by raising investment for an outcomes-based contract from retail investors. In particular it sought to evaluate whether such products could be distributed through financial advisers, who provide regulated investment advice to clients.

The bond combined a low risk loan to a social housing provider with a high risk investment in a social impact bond. This was designed to return investors’ principal on maturity with a variable return according to the success of the SIB.

The Essex Social Impact Bond

The focus of this market test was selected as the Essex Social Impact Bond, developed by Social Finance Limited on behalf of Essex County Council. The Essex SIB had already secured its full capital requirement from a number of institutional investors and one of these, the Esmée Fairbairn Foundation, offered to scale back its commitment by up to £200,000 to accommodate investments via the FfC bond in the interests of broadening the social investment market. This provided the opportunity for Allia to test whether capital could be raised from individual investors without presenting any risk to the SIB.

Investments in the SIB will help to fund a programme of support for children at risk of entering care. It aims to divert young people from entering the care system by supporting them at home, and, by doing so, improve their school outcomes, their well-being and reduce their risk of reoffending. To do this, CSSL has contracted the charity, Action for Children, to offer a programme of Multisystemic Therapy, which will provide intensive support to children and their families in Essex.

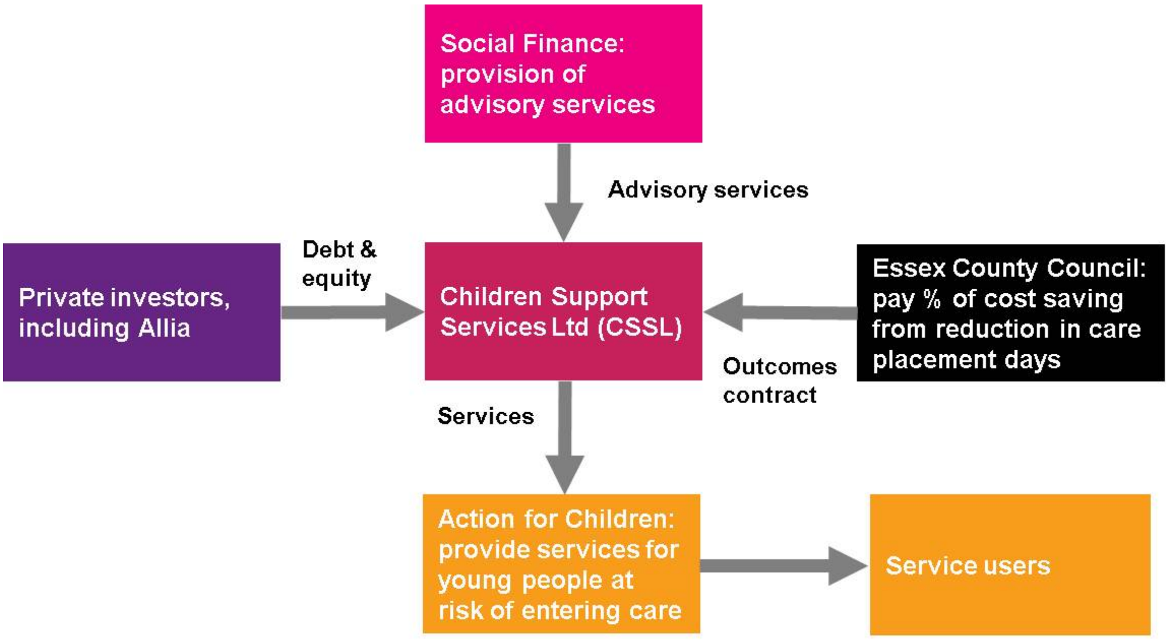
Multisystemic Therapy

Multisystemic Therapy (MST) is an intensive family- and community-based treatment programme that focuses on environmental systems that impact chronic and violent juvenile offenders—their homes and families, schools and teachers, neighbourhoods and friends. MST recognises that each system plays a critical role in the lives of young people and requires attention when effective change is needed to improve the quality of life for youth and their families. [1]

[1] Multisystemic Therapy website

The diagram below shows the partners involved in the Essex SIB and the services that each are providing:

Links between partners in Essex SIB—Children Support Services Ltd



Structure

The offer by Allia Ltd was for up to £1m Limited Recourse Bonds with an eight year term (due 2021). The offer opened on 4th February and closed on 12th April 2013, following a four week extension of the offer period from 15th March.

Limited Recourse Bonds

A bond in which the investor has limited claims on the issuer in the event of default. In the case of the FfC Bond this means Allia would only repay investors to the extent that it received repayment from the social housing provider and a return from the investment in the SIB. Bondholders would have no recourse to the general assets of Allia.

The bond was comprised of two investments:

- **An eight year loan to the social housing provider Places for People Homes, designed to protect the investor's capital.**

  Places for People Homes (PfPH) is a not-for-dividend registered provider of social housing. It is one of the largest property management and regeneration companies in the UK, with a Moody's rating of A1, and has raised £180m through retail bonds in the past two years. The loan would provide the capital protection for the product and comprised 78% of the investment. A similar structure has been used by Allia in the past and has also been reviewed by NPC.[2]

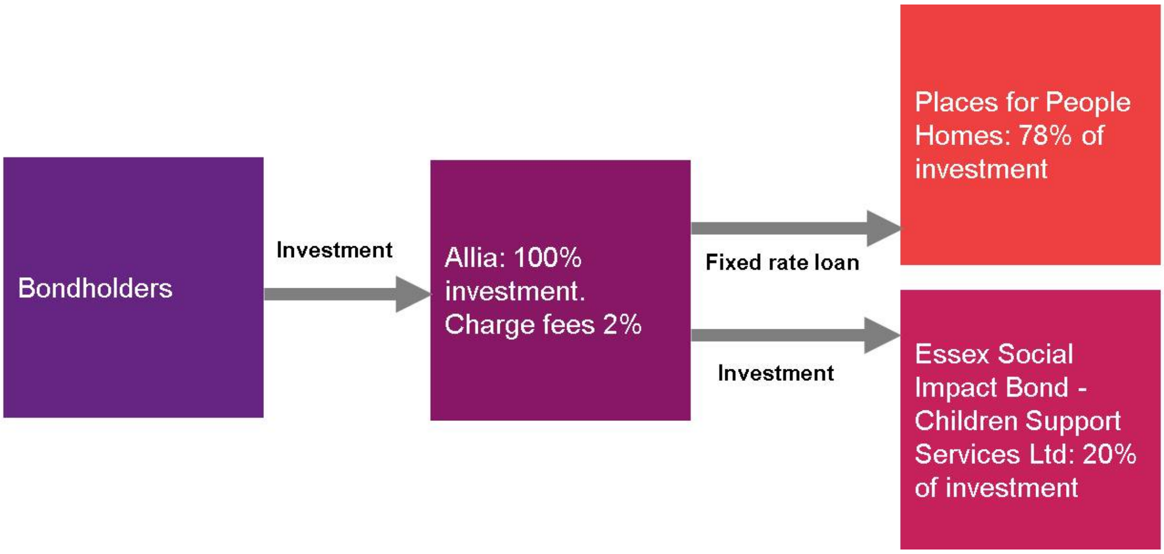
- **An investment in the Essex social impact bond (SIB) via the company Children Support Services Limited (CSSL), designed to provide a variable return**

[2] Hedley,S. and Joy, I. (2011) Review of Allia's charitable bonds. New Philanthropy Capital.

CSSL is the company set up by Social Finance to manage the outcomes-based project providing Multisystemic Therapy (MST) services to children on the edge of care in Essex, and accounted for 20% of the investment.

The remaining 2% is Allia's fee to cover its costs of managing the bond over the eight year term.

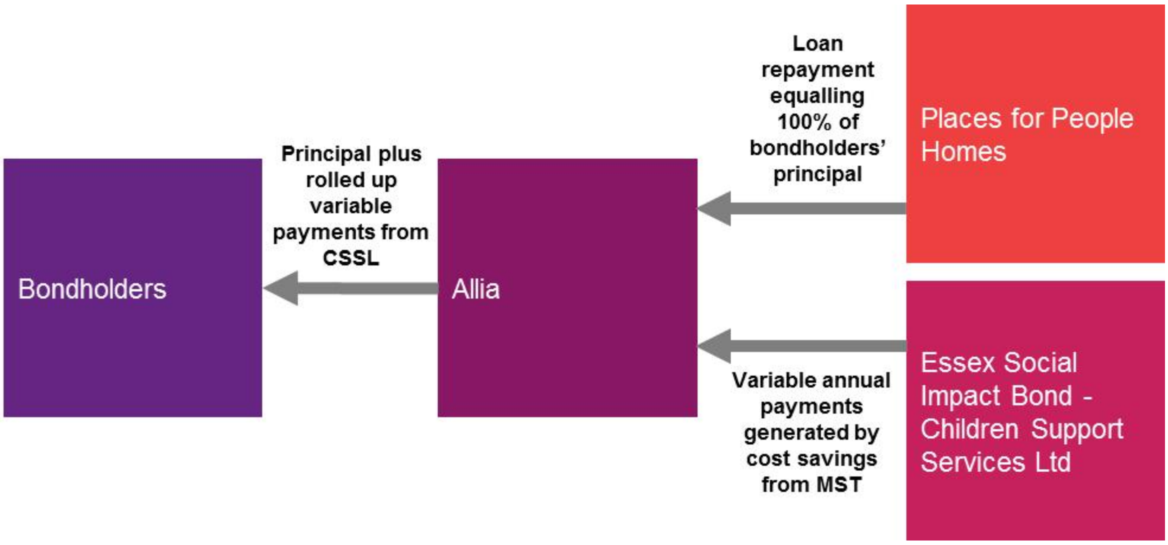
Summary of fund flows for bondholders—Investment Year 1



The total return to the investor in the FfC bond at the end of the eight year term would come from:

- the repayment of the fixed rate loan to PfPH plus compound interest, which would equal the principal amount invested by the bondholders;
- a variable return from annual payments from CSSL. If the programme is successful in reducing the amount of time children need to spend in care it will result in cost savings for Essex County Council. This can be used to provide a return to the investors in the SIB. The variable return would have been rolled up to maturity and comprises the 'interest' element of the bond. Although a financial model had been created by Social Finance, the assumptions underlying the model were subject to confidentiality restrictions with Essex County Council and therefore Allia was unable to give any indication of the range of returns that were possible from this investment.

Summary of fund flows—Returns to bondholders Year 8



Demand

Following the closure of the offer in April 2013, Allia decided to not go ahead with the FfC bond because the level of capital subscribed was insufficient to enable Allia to meet the costs of issuing and managing the bonds over the eight year term. The SIB however remains fully capitalised and has now gone ahead as originally planned, despite the fact that the FfC bond was not issued.

The social investment market

Stage

Although interest in social investment is growing rapidly, the market is still at an early stage of development [3] and is generally perceived as a high risk investment by advisers. The lack of regulatory clarity on social investment has contributed to this view. However, the regulator has recently presented guidance on social investment[4], illustrated in the diagram below, the most notable aspect of which recognises that *'for part of the portfolio, making a financial return may not be a client's only or primary objective'*.

Guidance on Social Investment from FSA in Retail Distribution Review Newsletter February 2013 and at the Worthstone Social Investment Academy in February 2013.

Commentators also cite the limited track record of social investment due to the shortage of available products, low levels of liquidity, and poor transparency of returns as additional factors further underlining the perception of social investment as high risk. Furthermore, new markets tend to have weak links between product providers, advisers, and asset allocators[5], which can result in product providers, such as Allia, facing difficulties in raising finance.

Financial promotion regime

A financial promotion is a communication of an invitation or inducement to engage in investment activity, such as entering into an agreement to buy or sell shares. It can be oral or written.[6]

3 Baker, L. and Goggin, N. (2013) Charities and Social Investment. A research report for the Charity Commission. IVAR.
4 Retail Distribution Review Newsletter, February 2013, Issue 9. FSA.
5 Nicklin, S. (2012) The Power of Advice in the UK Sustainable and Impact Investment Market. Bridges Ventures.
6 Practical Law Company.

Suitability requirement

When a firm makes a recommendation to a customer or selects an investment for a customer's portfolio, the firm is required to take reasonable care to ensure the suitability of its advice and discretionary decisions. In doing so, it must take into account the customer's interests, knowledge and experience, financial situation, investment objective, understanding of the risk involved and ability to bear any associated financial loss.[7]

Demand

Recent research into the demand for social investment does suggest that there is interest in such products amongst retail investors. The report, *Investing for the Good of Society* [8], suggests that many individuals with investment assets over £100k can be motivated to try social investments. Subsequent research also found that financial advisers believe there is an interest in social investment among their clients[9], but they are currently unable to identify which clients might be the most receptive. The report recommends defining social investment as a separate asset class and assigning it a separate pot of assets, surplus to those required to ensure financial security.

Supply

The supply of social investment products has been limited to date and products have tended to be bespoke and are therefore expensive to create. Lord Hodgson's review of the Charities Act 2006 highlights *'a lack of affordable off the shelf investment products'* in social investment[10]. However, the pace of deal flow is increasing and the need for products with lower cost structures that can be offered to retail investors is recognised.

Intermediation

Despite increasing demand and supply of social investment products, intermediation remains a weakness in the market, namely the linkages between the product providers, the investors and advisers. It is difficult at present for investors to seek advice on social investment, either about where to source investment opportunities, or whether to invest once an opportunity is presented. Part of this lack of advice is due to the unclear regulatory framework, discussed in more detail later in the report, but partly it's a consequence of the early stage of the market. The linkages need to be addressed quickly in order for the market to develop.

The marketing strategy

The marketing strategy for the FfC Bond consisted of two elements: promoting the bonds directly to retail investors through PR and social networks; and engaging with financial advisers to communicate the offer to their clients.

Allia decided, with advice from its partners, that due to the complex nature of this product it was important to protect the consumer from the risk of 'mis-buying' (i.e. buying a financial product that was inappropriate for their needs). Allia therefore made the Bond an 'advised' product—meaning that applications would have to be completed on a client's behalf by a person authorised by the Financial Conduct Authority (FCA – formerly the

7 Ruddell, K. (2011) Assessing Suitability, Farrer & Co.

8 Elliott, A. (2011) Investing for the Good of Society. The Fairbanking Foundation, Nesta, Ipsos MORI.
9 Elliott,A., Francis,G. and Knott,G (2012) Financial Planners as Catalysts for Social Investment. Nesta, Worthstone.
10 Lord Hodgson of Ashley Abbotts (2012) Trusted and independent: giving back to charities. A review of the Charities Act 2006. The Stationary Office Ltd.

Financial Services Authority). In other words, an individual investor could not directly apply for the bond, but needed to ask a financial adviser to apply on their behalf. This was the case even for sophisticated investors or high net worth individuals—see box below for the regulators' definitions of different types of investors. Allia wanted to ensure that investors did not apply for the bond without really understanding its terms, potentially being reliant on its expected income of which there might be none. It also wanted to protect itself against any claims of mis-selling by investors who bought the bonds inappropriately.

In fact, Allia received an application from one adviser on behalf of an individual who wanted to invest £40,000 in the bond, but the individual had not understood that there would be no regular income from the product. When the individual contacted Allia about another matter and discovered this fact he realised that the product was inappropriate and had to withdraw his application. If he had been able to apply directly and the bonds had been issued before he realised his mistake, he could have made a complaint against Allia to the FCA who would need to investigate whether Allia had mis-sold the bonds.

Types of investor

A sophisticated investor is someone who meets at least one of the following criteria:

Member of a network or syndicate of business angels for at least the six months preceding the date of the certificate;

Made more than one investment in an unlisted company in the two years preceding that date;

Worked in a professional capacity in the private equity sector, or in the provision of finance for small and medium enterprises in the two years preceding that date;

Director of a company with an annual turnover of at least £1 million in the two years preceding that date.

A high net worth individual is one with:

An annual income of £100,000 or more during the financial year immediately preceding the date of the certificate; and

Net assets of £250,000 or more throughout the same year.[11]

Due to the 'advised' nature of the product, part of the marketing strategy was to engage a panel of financial advisers that would be familiar with the bond, available to provide advice on the product to interested investors who did not have a financial adviser and complete an application form on their behalf.

Based on the advice it received, Allia set the minimum subscription level at £15,000, above the ISA subscription limit of £11,280, to prevent mis-buying and because the bond was seen as a complex and sophisticated product.

Allia worked with two external agencies:, Worthstone, a specialist consultancy to advise on the product development, marketing and distribution as well as facilitate access to socially-minded financial advisers; the other a PR and marketing agency to manage the campaign.

Elements in the marketing campaign included:

- Seeking advice on the structuring of the bond to shape the product appropriately for distribution via financial advisers
- Development of campaign materials, including website and summary document
- The production of an independent product review for financial advisers[12]

[11] ICAEW.

[12] Product Review: The Future for Children Bond (February 2013). Worthstone.

- Delivering a CPD webinar for advisers to set the scene on social investment and regulation, with a specific focus on the FfC bond.
- Mailings to a database of advisers who had previously indicated interested in social investment products to invite them to the webinar and alert them to the launch of the offer and the product review.
- Targeted approaches to key advisers to alert them to the bond and invite them to join the referral panel
- A PR campaign to gain press coverage about the bond launch
- The creation of an ‘infographic’ to raise awareness about the bond through social media

As shown above, prior to and during the launch of the bond, a thorough marketing strategy was developed and implemented with different partners taking on specific tasks.

CHALLENGES AND LESSONS LEARNT

The interview process identified several challenges that arose during the launch and marketing of the FfC bond. We have divided these into the following sections:

- **Marketing the bond—**the challenges that relate to the marketing of the bond are partly a reflection of the embryonic stage of the market, but also relate to the difficulty of reaching interested investors through the adviser route.
- **Upfront issues for financial advisers**—the set of challenges currently faced by financial advisers surrounding regulatory uncertainties, business risks and costs, some of which are specific to social investment.
- **Bond features**—the challenges associated with the structure of the FfC bond itself.

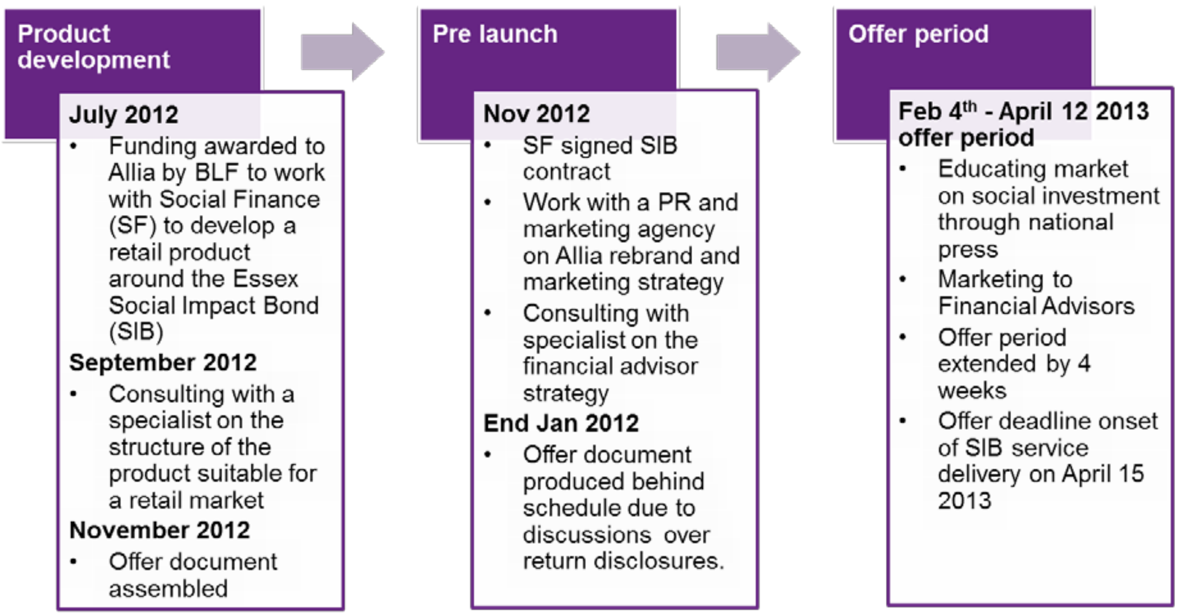
For each of these areas the lessons learnt are recorded and, where appropriate, recommendations are made.

Marketing the bond

As previously described, the bond was primarily marketed to retail investors through a combination of press articles and via their financial advisers. The challenges that arose are set out below.

Advisers found the bond offer period too short

The period between getting the go ahead from the Big Lottery Fund to launch the bond and the close of the offer was short, as illustrated in the diagram below:



Allia wanted to invest in the Essex SIB at the same time as other institutional investors. The deadline for investment in the FfC bond was therefore set to coincide with the commencement of service delivery in Essex in April 2013. Although it would have been technically possible to invest at a later date, this would have incurred additional legal costs and the difficulty of an interim valuation.

The production of the offer document was delayed . It was not possible to find a solution to the transparency problem, which had been identified earlier, because the basis of return on the Essex SIB investment could not be shared with retail investors due to confidentiality clauses with Essex County Council. Allia and their partners tried unsuccessfully to resolve this issue, which contributed to the delay. The result was that several of the initiatives planned for the marketing period before the launch did not take place, including flagging the product to advisers in advance, communicating with the industry opinion-formers and recruiting a panel of advisers willing to advise interested investors without their own adviser.

Various interviewees suggested that if the product's offer period had been longer, it might have been easier for advisers to discuss the bond to a wider range of clients. This is due to the fact that many advisers conduct annual or bi-annual wealth planning conversations with their clients (where they could have discussed the bond), rather than suggesting products to clients throughout the year as and when they are launched.

Low levels of knowledge across market on social investment

Allia was pleased with the level of coverage of the launch of the bond by the national, regional and specialist media, which included the Independent on Sunday, Financial Times, Money Week, Evening Standard and Economist. However, the level of knowledge of social investment across the market was lower than expected and it took significantly more resource than anticipated to convey the message.

The Sunday Times[13] mistakenly attributed the range of returns on the SIB, which Social Finance had previously indicated in public documents, as the potential returns on the FfC bond. Since these figures only related to potential returns on the 20% of the FfC bond invested in the SIB, they were significantly higher than any estimated overall return on the FfC bond. However, considering the innovative nature of the product, it was encouraging that this was the only instance of mis-reporting, and it was quickly addressed.

The webinar on social investment to introduce the FfC bond alongside a basic introduction to social investment was part of this wider education of the adviser market. It was encouraging that those who watched the webinar stayed online for the duration and asked relevant questions.

Difficulty in raising demand from retail investors

As part of the marketing strategy, the press campaign aimed to raise retail investor demand by prompting investors to approach their advisers and ask about the product. And as mentioned above, a good media coverage of the bond was generated despite the constraints over what Allia could say in the press release regarding expected returns given the transparency issues of the social impact bond.

It is difficult to gauge the overall success of this media campaign given the large number of factors contributing to the lack of take-up. Allia received a number of enquiries and applications from investors as a direct result of the press coverage, though the two investors interviewed by NPC communicated that they knew about the product through familiarity with the Essex SIB, and not through the related press coverage.

The second strand of the overall marketing strategy was to engage advisers through direct marketing. The advice given to Allia in October suggested that financial advisers could provide a distribution route to high net worth investors based on research showing evidence among these investors of an interest in social investment[14]. However the lack of established distribution channels for these types of investments meant that it was difficult to

[13] Make a difference to young lives and earn a 12% return (February 2013). The Sunday Times.

[14] Elliott,A., Francis,G. and Knott,G (2012) Financial Planners as Catalysts for Social Investment. Nesta, Worthstone.

identify the most appropriate financial advisers to target. Hence, Allia and its partners organised a CPD webinar on social investment, Worthstone led this initiative utilising its database of advisers. The webinar set the scene for social investment and included a specific focus on the FfC bond. The webinar was watched by approximately 25 advisers and around 100 more watched the playback subsequently after an email alert.

The independent product review on the bond was well received by those we spoke to who had seen it.

Distribution channels not yet established

This product was designed to test individual retail investors' appetites for investing in the social investment market. However a major challenge facing Allia was that the social investment market does not yet have established distribution channels to a wide pool of investors.

A number of direct, private placements to high net worth individuals have been made previously for high risk and complex investments, including the Greater London Authority SIB working with rough sleepers. Allia's objective was to determine whether capital for a SIB could be raised from a public offer by distributing through financial advisers.

To reach financial advisers Allia relied on communications through a third-party to its database of individual advisers from mainstream firms known to be interested in social investment products, as well as using its own contacts with local firms and private banks. Allia also marketed more widely to the adviser community, though primarily for the purpose of brand-building and raising awareness about social investment as it was considered unlikely that advisers would engage with the FfC bond through 'cold contact' and without being personally motivated by a desire to help clients invest money for social benefit.

The very low level of available social investment products to date however means that there are not yet well-established distribution channels and processes for drawing attention to such products and the percentage of advisers currently showing an interest in these kind of products is very limited. Although by no means restricted to them, ethical advisers were identified as potentially interesting group to target, but to put this into context, one adviser commented that the ethical adviser market is very small (less than 100 advisers out of more than 20,000).

As a result it proved difficult to identify and engage with relevant advisers. Allia appeared to be at a disadvantage by not having many established, direct relationships with financial advisers, though the marketing campaign did enable it to start building those relationships and identify some of the advisers who are most sympathetic to social investment.

A larger volume of social investment products, greater brand awareness of product providers and a better identified, more cohesive group of socially-minded advisers are all needed to distribute such products more effectively in future.

Lessons learnt and recommendations

- The development and marketing of complex financial products is time-consuming, especially in a new market such as social investment. Since the FfC bond responded to an opportunity surrounding the Essex SIB, Allia could not delay the offer period, which resulted in insufficient time spent on building profile before the launch, flagging the product, and connecting with opinion formers. In future, consultation and communication throughout product development is advised as well as a timetable that allows for a degree of flexibility.
- It is recommended that future products have a longer offer period combined with more time devoted to awareness raising about the product with the adviser community, so that advisers can discuss the products during annual wealth planning conversations.

- Social investment is not well understood by journalists and advisers alike, consistent with a low level of awareness associated with a new market. Future product providers should take into account the extra time and resource required to build knowledge amongst the target market and factor this into their offer schedules.
- Allia had a limited number of established, direct relationships with financial advisers. If advisers are to become a viable distribution channel for social investment products, providers need to develop stronger relationships with advisers and engage with them at an early stage to enable feedback to be incorporated into the product design and to gauge potential investor demand.
- The implications of the minimum subscription and the 'advised' nature of the bond were a challenge. It was important to ensure that investors buy a product that is appropriate for them, but these protection measures limited the pool of potential investors. Future products of this nature may need to remain restricted to targeted placements with higher net worth social investors until the social investment market is more developed.

Upfront issues for financial advisers

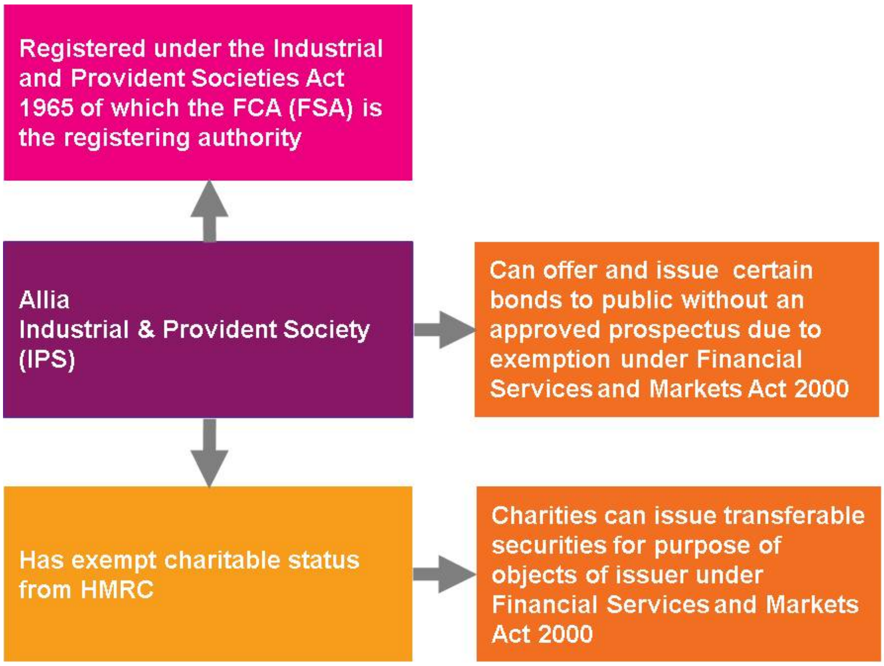
The FfC bond was an ‘advised’ product that required applications to be completed on a client’s behalf by a person authorised by the Financial Conduct Authority (FCA), formerly the Financial Services Authority (FSA). And yet, from the financial advisers’ business perspective, the FfC bond posed several challenges which made the risk-return element of advising on the product highly challenging.

Recognition of Allia low

Allia is an Industrial and Provident Society founded in 1999 under the name Citylife and registered with the FCA.

An Industrial and Provident Society is an organisation conducting an industry, business or trade, either as a co-operative or for the benefit of the community, and is registered under the Industrial and Provident Societies Act 1965.[15]

Advisers were not familiar with Allia as an organisation nor its status as an Industrial and Provident Society. The regulatory structure surrounding Allia and the bond issue is shown in the diagram below:



This unfamiliarity with Allia and Allia’s lack of a track record in this specific area were recognised as potential obstacles, hence the focus on building Allia’s brand in the marketing strategy. Although the short-term impact of the brand-building exercise is not apparent from the research, it is likely to benefit Allia in the longer-term.

Timing of the offer during an uncertain and busy period for advisers

The launch of the FfC bond came at a difficult time for financial advisers. From a practical perspective, the offer coincided with the end of the tax year, which is traditionally a busy time for financial advisers.

In addition, advisers have recently had to adjust to the Retail Distribution Review (effective 31 December 2012) and the implications it has on their business. Under RDR, financial advisory companies have to set out the

[15] Financial Conduct Authority.

charges the client will pay and agree them prior to providing any advice. One adviser suggested that this was the biggest change the adviser market had seen in 20 years.

The offer also coincided with a change in the structure of regulation in April 2013, as the Financial Services Authority (FSA) was split into the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA), both operating under the Bank of England. The PRA carries out the regulation of financial firms, including banks, investment banks, building societies and insurance companies. The FCA is responsible for regulating conduct in retail and wholesale markets with the objective of protecting and enhancing confidence in the UK financial system. The FCA is expected to be more hands-on than the FSA and bring a renewed focus on risk management.

Allia had little control over the timing of the offer. The schedule of the Essex SIB, into which the FfC bond was investing, was fixed by the terms of the service delivery contract and therefore limited the window and timing of the offer.

The advisers we interviewed felt that the offer period of six (extended to 11) weeks was too short to undertake adequate due diligence, recommend the product to their investment committee, and offer to suitable clients. It was also highlighted that advisers generally meet with their clients to review their investments on an annual basis; if the offer period does not coincide with this annual meeting, it can be extremely difficult for advisers to suggest the product to their clients. An open-ended product may be more suitable for this market.

Regulation on social investment just starting to emerge, and presents barriers

The FCA's stance on the suitability of social investment was not clear to the financial advisers we interviewed. One interviewee suggested that the regulator was engaged and moving in the right direction, pointing to their recent confirmation that for *'part of a portfolio making a financial return may not be a client's only or primary objective'* stated in the Retail Distribution Review Newsletter[16] and the regulator's presentation at the Social Investment Academy in February 2013. However, the general consensus was that financial advisers will need greater support from the FCA before feeling confident enough to advise on social investment.

Suitability is *'the critical test for whether or not a particular investment can be recommended to or made of behalf of a client'*[17]. For an 'advised' product, the risk of providing unsuitable advice to a client lies with the financial adviser. The conduct of an adviser should be the same for social investments as for financial investments: the adviser should ensure that the product is suitable for their client's needs and that the client is aware of all the risks involved. While some advisers were willing to join the adviser panel, one adviser we interviewed stated that they were unable to advise a client on a single product without going through the whole financial planning process.

One interviewee felt that without sufficient FCA guidance it is the responsibility of the individual firm to ensure that robust processes are in place to evidence suitability. However, the advisers we spoke to do not have a discovery practice within the client financial planning process for ensuring suitability for social investment, as they do for financial investments[18]. This has contributed to an unwillingness to offer advice on social investment[19].

Following RDR, advisers must also meet a higher benchmark for training and continuing professional development. However, training and continuing professional development (CPD) on social investment has been limited so far, which makes it difficult for advisers to demonstrate competence in this area and feel confident

[16] Retail Distribution Review Newsletter, February 2013, Issue 9. FSA.
[17] Bates Wells and Braithwaite (2012) Ten Reforms to Grow the Social Investment Market.

[18] Bates Wells and Braithwaite (2012) Ten Reforms to Grow the Social Investment Market.
[19] Lord Hodgson of Ashley Abbotts (2012) Trusted and independent: giving back to charities. A review of the Charities Act 2006. The Stationary Office Ltd.

about judging suitability. The situation is exacerbated by a lack of comparable products and an absence of expert intermediaries providing independent advice.

Advisers were also concerned about the soon to be published findings from the FSA Consultation Paper CP12/19: Restrictions on the retail distribution of unregulated collective investment schemes (UCIS) and close substitutes[20]. As of June 2013, the FCA changed the rules and now bans the promotion of UCIS to ordinary retail investors. Previously, advisers were able to promote UCIS to retail investors if the adviser had assessed the product's suitability. UCIS and close substitutes may invest in *'assets which typically are not traded in established markets and which are therefore difficult to value and may be highly illiquid'*. Although the FfC bond was not a UCIS, the uncertainty about whether it could be classified as this type of investment added to advisers' reluctance to consider the bond.

One adviser raised the issue that since regulation covers the whole product offered to investors, the regulator would also need to assess whether the information in the financial promotion about the projected social returns of a product were also fair, clear and not misleading. In this instance, if the investor made an investment decision based upon the expected social outcomes of the Essex SIB and the programme does not achieve those outcomes, the implication is that the client could potentially have a mis-selling case against the adviser if the risks of the outcomes not being achieved were not sufficiently communicated.

The cost of advising on social investment is high for advisers

From a business perspective, advisers felt that the cost of advising on social investment outweighed any benefits, such as the potential to expand and deepen their client relationships. This view is consistent with the report, *The Power of Advice in the UK Sustainable and Impact Investment Market,* which suggests that the 'slivers' of demand within organisations do not merit the investment in resources needed to serve that demand[21].

Following RDR, financial advisers are now required to charge for the advice they give to clients. One adviser suggested that, as a concept, this is not well-rooted in advisory practice the UK and even less so with regard to social investment. Moreover, advising on social investment brings additional costs through extra time required to train advisers, educate clients, conduct additional compliance and due diligence, pay potentially higher private indemnity costs and adapt systems. The full cost of advising on a social investment product was estimated at £1,000 by two advisers.

Compliance costs for social investment are also high because little is known about the market and financial advisers are extremely wary of the risks involved, especially as product selection is under close scrutiny from the regulator. Due diligence on complex products takes more time and the product literature has to be of a high standard; furthermore, advisers do not seem to know how to undertake due diligence on social impact. Overall, research by Worthstone[22] found that the more resource required to understand a product, the less likely it is that the product will be considered, especially if it is only relevant for a few clients.

In the absence of FCA and best practice guidance on suitability, social investment is either unlikely to be covered by professional indemnity insurance (PII) or any PII could be very expensive (as it is for unregulated products). If a product is not covered by PII, the risk of a product being deemed unsuitable during the period that it is owned by an investor lies with the adviser, which increases the cost of advising on the product. Advisers cited the uncertainty surrounding PII cover as a factor in their reluctance to engage with the product. In addition, the Financial Services Compensation Scheme does not apply to the bonds because, as an Industrial and Provident Society, Allia is not covered.

[20] FSA (2012) Consultation Paper CP12/19 Restrictions on the retail distribution of unregulated collective investment schemes and close substitutes.
[21] Nicklin, S. (2012) The Power of Advice in the UK Sustainable and Impact Investment Market. Bridges Ventures.
[22] Elliott,A., Francis,G. and Knott,G (2012) Financial Planners as Catalysts for Social Investment. Nesta, Worthstone.

Lessons learnt and recommendations

- Currently, financial advisers do not have a planning process in place that accounts for their client's social goals. This report agrees with the findings from the Expert Working Group[23] recommending that advisers ask their clients about their social and philanthropic goals during the discovery process.
- Continued engagement by the regulator is necessary to build financial advisers' confidence in social investment. More guidance is required on how suitability is viewed in the context of social investment.
- Financial advisers have not worked out the business case for advising on social investment products. The risks to their business presented by a lack of clarity on the regulatory side are matched by the practical difficulties of recommending these products from an internal compliance perspective. Product providers must understand the financial advice business model and develop products that fit within it, ensuring that products are simple and familiar.
- Social investment is not well understood by the professional indemnity insurers, which acts as an impediment to the development of the market. PII favours a full fact find and documented discovery process surrounding social investment, as recommended above.
- The social investment sector should work together to provide training and education that will satisfy the continuing professional development and suitability requirements that financial advisers follow. Better education of advisers (and clients) on social investment will ultimately lower the cost of advising on social investment in the long term.

Bond features

The FfC bond was an opportunity for retail investors to invest in a social impact bond for the first time. The structure of the bond was partly based on the charitable bonds that Allia had developed over previous years, but it was also decided to an extent by the structure of the Essex SIB that had already been agreed between Essex County Council, Social Finance, and the private investors.

Feedback on the structure of the product highlighted several problematic areas.

Advisers found the bond structure too complex

During interviews most advisers indicated they found the structure of the bond to be too complex. Advisers are not familiar with limited recourse bonds and there is a lack of understanding around the counterparty risks involved, further increasing the perceived high risk of the bond. Recent research refers to the need for a recognised legal structure that might better appeal to the public[24].

The bond is not an income product, which caused some confusion during the offer. It was decided that any annual payments accruing from the payment by results contract with CSSL would be rolled up and paid out at the end of the period.

One adviser saw the asset backing offered by the investment in Places for People Homes as an unnecessary complication, diluting the investment in the social impact bond. Overall, advisers understood that the housing loan provided an element of capital protection, but at the expense of total return.

One adviser felt that the product offered dual social impact—providing both social housing and support for children on the edge of care—whilst others commented that the social impact was quite specific and geographically limited to Essex, which made it less interesting to clients, for example those based in Scotland.

[23] Advising Clients on Social Investments and Deciding on Suitability (2012) The Report of an Expert Working Group. Big Society Capital, Bates Wells Braithwaite, Worthstone.

[24] Baker, L. and Goggin, N. (2013) Charities and Social Investment. A research report for the Charity Commission. IVAR.

It is interesting to note that Worthstone[25] recommends keeping social investment products for the retail market as similar as possible to existing products, and restricting innovation to that around the social impact, rather than the final product.

Investor protection measures potentially an obstacle

Allia was advised to set the minimum investment at £15,000, higher than the current ISA allowance of £11,520. By combining this minimum subscription with the need for advice (as mentioned earlier, the bond was an 'advised' product), Allia ensured that the product was only sold to high net worth investors who could afford to pay for the advice.

Some advisers we interviewed regarded this minimum investment level as too high for most retail clients and also for socially-minded investors who might be looking to make their first exploratory investment.

And the 'advised' nature of the product did reduce the pool of potential investors although on balance, the requirement for advice was regarded as prudent since this is a sophisticated product. Part of the marketing strategy was to engage a panel of advisers willing to advise interested investors without an existing adviser. Initial discussions with advisers showed there was interest in some of them joining such a panel and having investors referred to them. However, in practice, some felt unable to do this without undertaking a full financial suitability assessment of the client. The cost to the financial adviser and investor of undertaking this would likely be prohibitive for one investment.

Restrictions over the transparency of bond returns

Allia had not intended to launch a bond with such restrictions over forecasting its expected returns. In the late stages of product development, it was established that the confidentiality clauses in the Essex SIB contract prevented some details from being communicated to retail investors, including the nature of the outcomes data, and the assumptions and costs behind the financial model for the SIB. As a result Allia was unable to give a forecast return for the bond nor information that would enable investors to understand the basis for return on the SIB part of the investment.

This lack of transparency surrounding the return on the bond increased the perceived risk of the investment and deterred advisers from engaging with the bond. Although it was understood that returns on a social investment product would be lower than returns on a pure financial product, advisers said that an illustrative return was necessary. This presented a significant challenge when marketing the bond to financial advisers and individual investors.

The two investors interviewed by NPC who applied for the bond had access to information about the underlying returns of the Essex SIB itself, and therefore approached the FfC bond with a greater level of understanding. They were able to calculate an approximate return for the FfC bond. This suggests that the availability of a range of expected returns might have encouraged a higher take up of the bond.

Risk-return trade off

Difficulty in understanding the risks

A report by the Boston Consulting Group suggests that understanding risk is one of the major impediments to investment[26]. In this instance, financial advisers had difficulty in understanding and pricing the two major risks

[25] Elliott,A., Francis,G. and Knott,G (2012) Financial Planners as Catalysts for Social Investment. Nesta, Worthstone.

[26] Brown, A. and Norman, W. (2011) Lighting the Touchpaper. Growing the Market for Social Investment in England. The Boston Consulting Group.

involved—the higher risk payment by results contract, and the lower risk secured lending to a housing association.

One adviser commented that the level of due diligence that was required to understand the risks surrounding the delivery and success of the Multisystematic Therapy intervention prohibited recommending the product. Another interviewee suggested that the poor outcomes from contracts already in place, such as the Work Programme, cast payments by results in a negative light.

It is NPC's own opinion that investors will become more comfortable with products such as Social Impact Bonds once a track record has been established.

Term too long for an illiquid product

The bonds would have had an eight year term to cover the five and a half year contract in Essex and allow for the subsequent measurement of outcomes of the payment by results contract. Advisers felt that eight years was too long and, although the bonds were transferable (and would have been traded on Ethex[27], a platform set up to develop a market in ethical shares), liquidity would likely be limited. There would also be difficulty surrounding the transparency of interim valuations since results take time to come through and success payments are only accrued annually.

Impact of inflation on returns

One adviser cited the impact of inflation on the capital backing over the eight year term as a problem. The cumulative impact of inflation, assumed at 2.5% over the eight year period, erodes the real capital protection of the investment in the housing bond by almost 20%.

Diversified products preferred

Advisers said that a diversified product, such as a fund, would better meet their suitability requirements in relation to spreading risk. The due diligence required on a fund requires less resource from the adviser. Much of the due diligence is focused on the track record and reputation of the product provider as opposed to the underlying individual investments.

No tax relief available

Currently, social investment does not qualify for any tax benefits. However, in the 2013 Budget statement the government announced that it will consult on introducing a new tax relief to encourage private investment in social enterprise, with a view to introducing this in the 2014 Finance Bill.

Advisers felt that tax benefits would bring social investment in line with other high risk investments such as VCTs and EIS structures, and improve the overall return to investors.

Lessons learnt and recommendations

- This market testing process confirmed that most retail investors are looking for similar characteristics in social products as in financial products—simplicity, transparency, liquidity, and diversification. The FfC bond did not possess these characteristics and therefore the retail market and the corresponding advisers found the product complex. . Raising capital from this market in the future will therefore require social investment products that are more similar to products that advisers are already familiar with.

[27] Ethex website.

- Advisers prefer products that can demonstrate a track record. Social Impact Bonds overall have not yet developed a track record with institutional investors. Once this has been established, products for the retail market will be more attractive to advisers and investors.
- This research was not able to test whether investors favoured the capital protection that was built into the bond or the willingness of investors to trade financial return for social return. It is recommended that future retail products should have a simpler structure which could test these characteristics more directly.
- The 'advised' nature of the product was prudent to protect 'mis-buying' of the bond and yet this limited the potential pool of investors. In addition the adviser panel, in the end, didn't suit some advisers' existing ways of working with clients and assessing product suitability. It would be interesting to test a non-advised product in this market.
- The same standards of transparency should apply to social investment products as to financial products. Successful retail investment in social impact bonds will require a willingness by all partners to disclose the basis of returns. It is suggested that future social impact bonds should be structured with the retail market in mind with regards to disclosure of information and transparency.
- The term of the bond was perceived to be too long; products that exceed five years raise concerns surrounding liquidity and the impact of inflation on the capital protection rises. Future products should take this into account, although it is recognised that social impact takes time to generate and impact products may therefore be longer term.
- Collectivised products, such as a fund of SIBs, are favoured for the diversification properties they offer investors and the lower burden of due diligence required.
- The minimum investment was viewed as too high, suggesting that exploratory investments in social investment products from retail investors are likely to be small, or should be targeted at higher net worth individuals or more sophisticated investors.
- Tax incentives could accelerate the market's development and improve the risk-return trade-off for investors.

CONCLUSIONS

The Future for Children Bond was an opportunity to test a retail investment product related to a payment by results initiative. In the end, the FfC bond was not issued due to a lack of demand, despite encouraging media interest in the product. However, the social impact bond has proceeded as planned.

This evaluation of the bond has highlighted several challenges from a marketing, adviser and product perspective, which provide valuable insights for the sector. Although it is not possible to attribute the reasons for the bond's low take-up to one particular aspect, the key lessons from this evaluation are:

- Transparency surrounding the returns of any social investment product is key. Confidentiality restrictions imposed on Allia regarding the nature of the payment arrangements between the Council and the service provider made it difficult for expected returns on the bond to be substantiated and this was clearly a major impediment to both advisers and potential investors, and arguably also the press.
- The marketing of products as new and untested as the FfC bond is likely to be time consuming and resource intensive requiring co-ordination and collaboration between the different players – product providers, institutional investors, financial advisers and professional bodies.
- The lack of established distribution channels to investors mean that it is difficult at this embryonic stage of the market to identify and engage the most appropriate advisers and investors. The success of future products will require the development of good relationships over a period of time with a range of financial advisers operating across the wealth spectrum.
- Further regulatory clarification is required on social investment and its suitability before advisers feel confident recommending products to their clients. In addition, advisers need to gain a better understanding of social investment overall—this will happen over time as the market develops and products establish a track record.
- In order to engage the adviser community, social investment products need to be simple, liquid and familiar. Advisers need products that they can quickly understand and that fit with their due diligence and business processes. Pooled funds of social impact bonds may be better suited to the retail market.

We recognise that the social investment market is embryonic and that there is a need to test a variety of products in order to work out which products a wide range of investors and their advisers are most attracted to. To date, much of the policy focus within the social investment market has been around social impact bonds. If, as the FfC bond has shown, it proves to be difficult to widen the appeal of social impact bonds and related products, it may be a useful learning to suggest that the social investment market should be developed not through a focus on social impact bonds but instead through the development of simpler social investment products.

The research suggests that this bond was perhaps ahead of its time but that useful lessons were learned for other products.

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