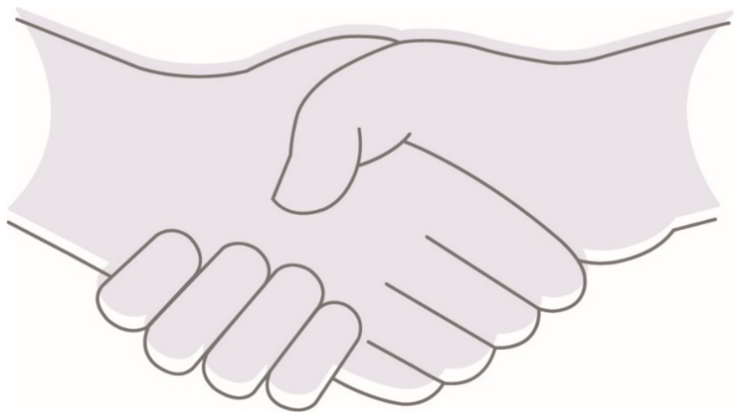


Essential Skills Social Finance

Phase I & II

Executive Summary

Colleges and Institutes Canada
Collèges et instituts Canada

Executive Summary

The Government of Canada is interested in improving its social programs to achieve better outcomes for Canadians. Accordingly, in October 2013, Employment and Social Development Canada (ESDC) announced that the federal government would be funding the Essential Skills Social Finance Pilot (ESSF Pilot or the Pilot) – the first social finance project of its kind in Canada for the federal government with the aim to test the principles and mechanisms of a social impact bond (SIB).

The principal objectives of the ESSF Pilot are to test the effectiveness of the SIB model for delivering essential skills training to improve the essential skills level of unemployed Canadians, to determine the market viability of a SIB instrument, and to understand the optimal conditions for its design and implementation in the Canadian context. Secondary objectives were to assess whether the SIB model is a better alternative to current government program funding models that could achieve better outcomes, provide greater value for money, and align with the interests of the public and private sectors. Gaining an understanding of how participant skill gains achieved during the intervention could be sustained over a longer period was also an important consideration. The ESSF Pilot was designed to be a proof of concept and limit the number of variables to test the application of the SIB model and establish the right incentives to meet the Pilot's overall objectives. In a SIB, program success is based on outcomes and not outputs, which are usually the determinate of success in traditional government programs.

Essential skills training offered a viable approach for addressing complex social problems while testing an innovative financial instrument such as a SIB. Thus, the Pilot was built around essential skills training as the intervention. Research has shown that improving the essential skills level of low-skilled and unemployed Canadians can lead to better employment outcomes and lead to higher income.

The Foundations Workplace Essential Skills Program developed by Douglas College was chosen as the intervention for the Pilot because it offered a blended learning approach with individualized instructional design. As well, it is unique in that the program effectiveness is supported by pre- and post-test essential skills scores (and skill gain) from more than 2,000 learners that spanned a six-year period. This data was used to determine the appropriate skill gain levels, which was used to determine the investor repayment formula.

This final report is divided into two parts, which reflect two different phases of the ESSF proof of concept. CICan, with support from the KPMG Canada corporate finance team, produced a report describing the first phase of the Pilot. The report was written for the Government of Canada and disseminated to key project stakeholders and partners only. The report provides a summary of observations and lessons learned as well as recommendations related to key activities and milestones from the start of the ESSF Pilot on September 18, 2013 through to the completion of securing investors on September 9, 2016. The report included a summary of the rationale for selecting the corporate and governance structure as well as observations and feedback from key stakeholders (investors that declined the offering, current investors, ESDC, CICan, Douglas College as the coordinating college, Social Research and Demonstration Corporation (SRDC) and KPMG).

CICan prepared part two of the final report with support from Douglas College. It includes the perspective of the college service providers and intermediary. Part two focuses on the second phase of the Pilot, which included the recruitment of participants, the implementation of the Foundations Program within the three service delivery sites, the performance evaluation of participants, and the payout assessments against a reimbursement formula. SRDC – responsible for the evaluation of the participants' skill-gain and the analysis of the payout to investors according to the repayment formula – will provide their own independent report to ESDC early in 2019.

The ESSF Pilot was an innovative and complex project which required different stakeholders with different perspectives and expertise collaborating to achieve an important social objective. Four principal stakeholders or parties participated in the Pilot:

1) The Government of Canada: Employment and Social Development Canada (ESDC), via the Office of Literacy and Essential Skills, is the outcome payer for the ESSF Pilot. ESDC had contribution agreements with CICan to act as the intermediary and with SRDC to measure the impact of the intervention. ESDC reimbursed CICan in accordance with the Pilot's reimbursement formula linked to participants' skill gain. Being a first of its kind proof of concept, ESDC provided funding for project costs associated with the design and testing of the SIB model to document the lessons learned. Under these circumstances, the Government of Canada shared the risk of designing and implementing an innovative model with CICan to deliver the Foundations Program to program participants.

2) Intermediary: CICan – through a general partner corporation established to limit CICan's liability, provide transparency for investors, and to maintain its charitable status – acts as the intermediary by being the general partner in a limited partnership (LP) structure. The LP was established to raise investment to fund the ESSF Pilot intervention. CICan also acted as the project administrator with the overall responsibility for the design, implementation and execution of the Pilot. CICan was responsible for repaying investors in accordance with the established repayment formula. CICan is accustomed to dealing with complex and large-scale projects with multiple stakeholders given its program management history. However, this was CICan's first time assuming the role of general partner.

3) College service delivery providers: Douglas College is CICan's coordinating college for the delivery of the Foundations Program and was responsible for quality assurance. Colleges from across the country responded to a CICan expression of interest to be part of the ESSF Pilot. Proposals were screened by an independent review panel. Saskatchewan Polytechnic, Confederation College, and Collège Lionel-Groulx were selected to join Douglas College as service providers. Collège Lionel-Groulx was later forced to withdraw from the Pilot because of logistical issues associated with participants receiving social support from the Province of Quebec.

4) Investors: The three investors in the ESSF Pilot are diverse organizations:

- The Catherine Donnelly Foundation, a private foundation with an impact investing mandate.
- Conexus Credit Union, a Saskatchewan-based financial institution and a credit union.
- Dave and Pamela Richardson and Family, Hight Net Worth Individuals contributing to and participating in several philanthropic initiatives.

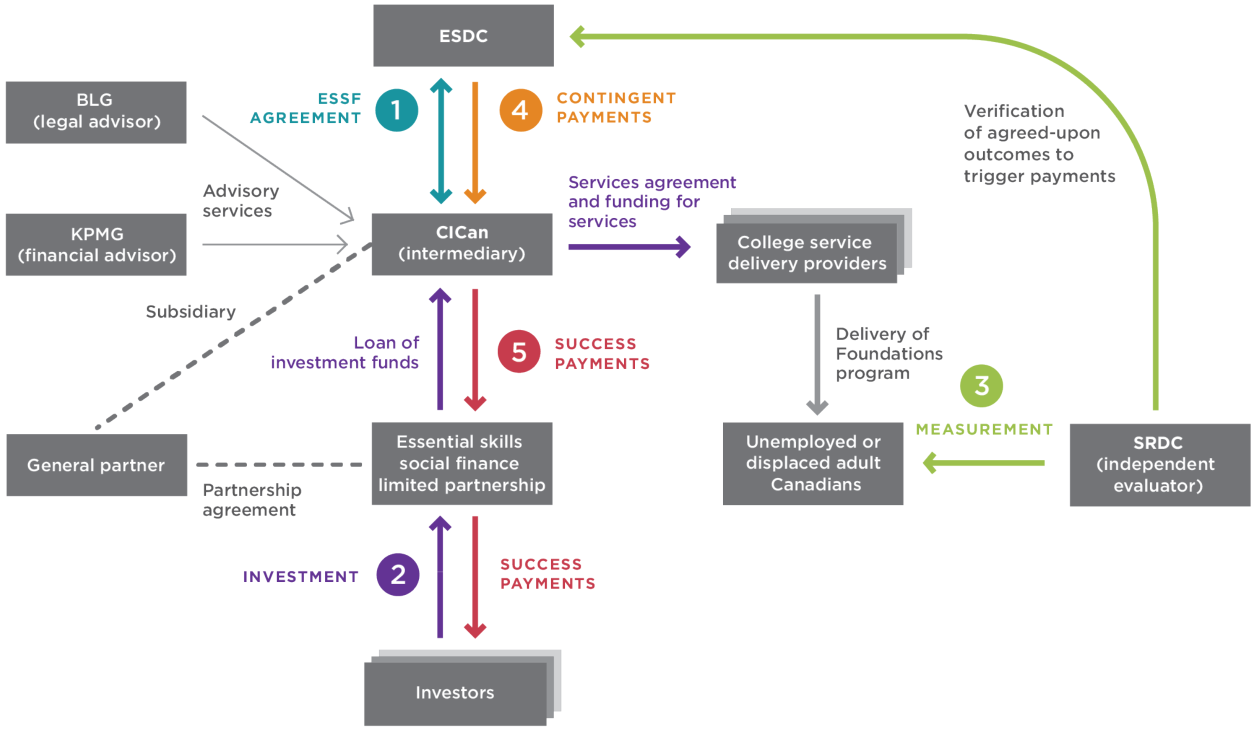
As the ESSF Pilot is very complex and technical in nature, it also requires the expertise of professional services advisors:

1) Independent evaluator: SRDC is the independent evaluator responsible for the evaluation of training outcomes, implementation analysis, and assessment of the effectiveness of the SIB model.

2) Financial advisor: retained by CICan, KPMG is a financial advisor to CICan and the limited partnership in matters related to the offering.

3) Legal Counsel: Borden Ladner Gervais LLP (BLG) is retained by CICan to serve as the legal counsel to CICan and the limited partnership in matters relating to the offering. They drafted and reviewed the various documents related to the transaction and partnership.

Figure 1. Overview of the roles of the principal stakeholders and the flow of funding



1. ESSF agreement: An agreement between ESDC and CICan pursuant to which CICan acts as the intermediary and manages the ESSF Pilot project. The contribution agreement reimburses CICan in accordance with the established repayment formula linked to participants' skills gain, and being the first of its kind, ESDC is also funding the project costs associated to CICan's design and testing of the model, and documentation of lessons learned of the Pilot.

2. Flow of investment funds: The investors subscribe to Essential Skills Social Finance Limited Partnership (ESSP LP) units, and the investment proceeds are loaned, via a principal at risk note, from the ESSP LP to CICan who is in turn using the funds to contract with each college service delivery providers to deliver the Foundations Program. A portion of payments to the college service delivery providers follows a pay-for-performance model and is contingent upon the number of participants achieving prescribed essential skills point gains at their college.

3. Measurement of results: SRDC administers essential skills testing that provides baseline results for each participant to the college service delivery providers for purposes of program delivery, and measures skill gains post-training and 12 months following post-training. From the results, aggregate gains are calculated and released to ESDC to trigger contingent payments as applicable.

4. Contingent payments: As warranted by the aggregated essential skills point gains, identified using the International Adult Literacy Survey (IALS) 500-point scale, ESDC makes the contingent payments to CICan.

5. Success payments: CICan uses contingent payments from ESDC to repay the principal at risk notes to the limited partnership. The limited partnership then returns capital and any earned return on capital to investors based on skills gains.

DESIGN CONSIDERATIONS: INVESTMENT STRUCTURE

The ESSF Pilot was established using the intermediary-contracting model and CICan is acting as the intermediary. When compared to precedent SIB structures, CICan's circumstance was unique in that CICan was an operating entity and not a dedicated intermediary with the further complexity of being a registered charity. KPMG assisted CICan to identify potential corporate structuring options through which they could receive and administer third party funds in a manner that would not jeopardize their charitable status.

Structuring options that utilize a special purpose entity to receive private party funds would enable containment of contractual obligations and liabilities within a special purpose entity rather than directly encumbering CICan. These options further improve transparency to investors, permit establishment of independent governance and could mitigate – but would not eliminate – risks to maintaining CICan's charitable status. KPMG provided four potential corporate structures options, and CICan selected the structure under which investment funds would flow through CICan to the service providers, and CICan would contract with all parties other than investors. The investment monies would flow from the special purpose entity to CICan, which could be achieved through an unsecured loan.

The objectives of implementing special purpose entity structures in select precedent SIB models included simplifying investor due diligence by segregating SIB related activities from non-SIB activities while providing for flexible governance frameworks. The selection of the specific special purpose entity vehicle was intended to achieve tax neutrality of the SIB structure, and did not contemplate tax advantages specific to prospective investor groups.

The special purpose entity was established as a partnership structure selected by CICan. The main advantage of this structure is the flow of both income and losses to partners in which the character of income is retained in the hands of the partners. Limited partnership investment structures are common in Canada, and would be reasonably understood by prospective investors. Other SIB examples which used a limited partnership as the special purpose entity include the Peterborough Project (UK) and the Essex Project (UK).

A key observation and lesson learned is the consideration of the potential benefits and constraints of the investment structure for all stakeholders. At the start of the Pilot, there were restrictions preventing registered charities from investing in limited partnership units due to the presumption that partners in a limited partnership carry on business for profit. This was identified as a key barrier, since charitable foundations were identified as key potential investors in the Pilot. This barrier was also one of the factors that contributed to an amendment to the Income Tax Act in 2015 that allowed registered charities to hold up to 20 percent of the interests of a limited partnership, as long the charity deals at arm's length with each general partner of the limited partnership.

DESIGN CONSIDERATIONS: CONTRIBUTION AGREEMENT

The funding for the Pilot was provided by ESDC to CICan through a contribution agreement, the transfer payment mechanism used by the Government of Canada that stipulates the maximum contribution of the Government to a recipient organization for the purposes of funding a project and the project activities eligible for funding. The original contribution agreement was signed with a start date of September 18, 2013 and spans the entire duration of the ESSF Pilot, originally from September 2013 to January 2016. ESDC believed the contribution agreement was the most appropriate transfer payment vehicle to use for this type of project as it lends itself to experimentation while maintaining accountability and the government's stewardship responsibilities for the use of public funds. The five-year life of the contribution agreement was also viewed to be an advantage.

Being the first Pilot of its kind for the Government of Canada and CICan, many of the decisions associated with the program were made with no precedent to reference in terms of a decision-making framework. Therefore, during the course of the Pilot, there has been a number of changes that required amendments to the contribution agreement to ensure proper due diligence in order to proceed. The amendment process with ESDC was lengthy, with some amendments taking over six months to negotiate and obtain necessary approvals. The amendments were mainly undertaken to re-profile funding from one fiscal year into the next, and extend the Pilot timeline due to delays in critical path activities.

One such delay included awaiting the Canada Revenue Agency's Charities Directorate ruling. In addition to the time spent awaiting the ruling, the additional time was needed to make the resulting changes to CICan's statement of activities and proposed purpose, and to obtain the subsequent approval by CICan's Board of Directors. Although not envisioned at the start of the Pilot, CICan was advised in the design phase of the project to form a special purpose entity due to the potential impact of the Pilot on CICan's registered charity status with Canada Revenue Agency (CRA). This delayed the formation of the special purpose entity required to establish the appropriate governance and investment structure that resulted in a significant delay in engaging investors which was done within a compressed timeline as the Pilot end date was fixed based on the terms of the contribution agreement. These identified unexpected and valuable learnings.

One benefit of the numerous amendments to the contribution agreement was that it engaged central agencies with the Pilot during the process, and had the effect of shared learning in real time. ESDC noted that this Pilot has allowed the Government of Canada to learn a great deal, and has also contributed to certain changes taking place to allow this type of innovative approach to flourish. For example, the Treasury Board of Canada introduced changes that are providing greater flexibility to the Government of Canada to encourage and support experimentation, like the introduction of the new generic terms and conditions for grants and contributions, effective as of April 1, 2017.

Observations and lessons learned include having two separate contribution agreements: one to govern the design phase of the project, and another for the implementation phase. This would provide the flexibility needed to focus on experimentation and development of an instrument that coordinates the engagement and needs of different principal stakeholders, and streamline the negotiation of critical clauses in the contribution agreement governing implementation.

IMPLEMENTATION CONSIDERATIONS: WRAP-AROUND SERVICES

Investors and college service delivery providers were interested in providing wrap-around services (services to complement the formal Foundations program) to increase the amount of support available to students. Many participants in the Pilot faced multiple socio-economic barriers to employment, and these wrap-around services provided the additional support they needed to attend class and have the most meaningful experience. For example, a high number of participants were food insecure and did not have access to transportation to and from class. All three service delivery colleges agreed to offer wrap-around services in addition to the Essential skills component of the curriculum, which included food during class, access to transportation to and from class, access to an individual computer during class time, and sessions on managing stress and learning mindfulness techniques.

The costs related to these additional services were not included in the original estimate of the costs per participant, and thus were not included in the contribution agreement for this Pilot. Given the value-add of the wrap-around services to participants, including a budget for these services in the contribution agreement of potential future iterations of the project would allow colleges and institutes to better support their participants' learning outcomes and success

PROCESS CONSIDERATIONS: ENGAGING INVESTORS

One of the key lessons learned was related to the emerging state of the social finance market in Canada at the time the Pilot began and the extended timeline that is required to launch a successful SIB. The ESSF Pilot provides one of the first opportunities for investors to consider investment in a SIB-type of transaction. The time to introduce the investment opportunity, socialize it with investors, and enable due diligence and decision making in accordance with their governance frameworks should not be underestimated. Therefore, the initial short timeframe to engage potential investors due to the various amendments to the contribution agreement described above did not allow for the implementation of a robust marketing strategy, and we heard from potential investors that the proposed timeframes were unreasonable.

All of the potential investors approached were experienced philanthropists, who carefully considered both the financial and social impact features of the transaction, and assessed programs from the point of view of a philanthropic investment. However, the due diligence of the social finance investment also had similarities to how traditional investors would consider subscribing to units of a limited partnership.

Another key lesson learned concerned investor needs and governance constraints. Certain investors wanted to be engaged in the design phase, others had a geographic focus to their investment strategy, while some were interested in investing, but had not yet socialized this type of investment with their Board of Directors or had not yet updated their internal investment policy to enable their participation in the ESSF Pilot, which the compressed timetable wouldn't allow time for the change.

Additionally, some investors expressed interest in meeting in-person with the Pilot participants throughout the implementation of the program. Devising creative ways to engage investors in the implementation process while respecting the barriers and potential vulnerabilities of the participants is recommended for future projects.

INVESTOR RETURN AND REIMBURSEMENT PAYMENTS

The agreed-upon investor reimbursement and return formula was developed using the statistical analysis from two reports completed in 2014 by SRDC. The first report reviewed the use of the International Adult Literacy Survey (IALS) in other essential skills training projects, and the second report estimated the outcomes of essential skills interventions and proposed an investor return structure. At the request of CICan, KPMG then modelled the expected investment performance distributions that corresponds to the investor payout thresholds proposed by SRDC in these reports. This informed ESDC's and CICan's decisions in establishing the payout thresholds, aligning the risk and return measures in a manner that was anticipated to be conducive in attracting investors.

In order to set a reasonable benchmark for the success outcome, SRDC analyzed historical results from Douglas College Foundations Program and several other essential skills training interventions, including UPSKILL, Workplace Training Program, and the National Framework project. The resulting payout grid included seven scenarios based on the median-point gain achieved by a percentage of participants after completing the Foundations Program, and the percentage of participants with a 25-point gain. In addition, investors may receive a second payout one year after participants have completed the Foundations Program, if they retain their test scores. Other considerations that were factored into the payout grid included the lack of liquidity inherent in this investment (relative to a liquid investment) and the credit risk of cash payouts to investors into the reimbursement payments.

It was also established that the college service delivery providers are to be reimbursed by CICan for delivering the Foundations Program from the proceeds of the offering at a fixed base rate and a smaller variable component, which represent a pay-for-performance payment that consider participants' skill gains. This reimbursement was established by CICan and was not part of the contribution agreement with ESDC.

A key observation and lesson learned was the design of the pay-for-performance payments to the college service delivery providers independently from the investor payout grid. This made it difficult to communicate the net effect of the investment to investors as the pay-for-performance payments to the colleges could not be applied against the investor payout grid to calculate a net return.

As well, some investors indicated that the return profile was a contributing factor to why they hesitated or declined to invest in the Pilot. They commented that the inclusion of a payout scenario putting 100% of their capital at risk was unappealing and that the return profile adequately compensated investors for the level of risk. They would have preferred a cap on the downside risk or a more equitable sharing of the risk between the investors and the Government of Canada, especially for the first offering.

OVERALL RECOMMENDATIONS AND CONSIDERATIONS

The ESSF Pilot was a very complex project that required diverse technical expertise from financial, legal, social impact, and outcome measurement perspectives. Early wins include tangible changes to the Income Tax Act, and success to date has been achieved in different ways by testing an innovative outcome-based approach that is an alternative to existing program delivery models within the limits of existing systems and norms. Other program delivery models being piloted by the Government of Canada, via the Office of Literacy and Essential Skills, are a pay-for-success employer model that encourages employer investment in essential skills training for their workers, and a social enterprise and social return on investment pilot.

The Pilot required collaboration among many different types of organizations from the government, colleges and institutes, and the private sector, each with different interests, accountabilities and decision-making processes. Critical to its success is understanding the different perspectives and needs of the various stakeholders, and involving them in key decisions to secure their support and willingness to act as champions over the life of the initiative. These decisions need to strike a balance between cost, transparency, flexibility, credibility, tax implications, and overall complexity to create the most effective outcomes for people that the underlying intervention is seeking to support.

The Pilot provides some key critical lessons learned that can be leveraged in the future, including:

- The experience emphasizes the importance of having collaborative and discrete 1) planning, 2) designing (deal structure and reimbursement), 3) investment offering & securing investors and 4) implementation phases.
- The addition of wrap-around services illustrated that the provision of additional supports to help participants overcome socio-economic barriers is critical to clear the path for successfully following through with training interventions.
- Ensure a charitable organization's status is protected by establishing the appropriate governance structure to facilitate the flow of capital. For example, CICan put in place a general partner and developed limited partnerships to manage investments.
- Providing an early proof of concept that allows flexibility within the existing model to innovate and get initial feedback from an independent evaluator, service providers and potential investors is a critical success factor.
- Investors emphasized that they prefer some form of tax relief to balance the risk associated with SIBs and/or the integration of a back-stopping element.

Other key considerations that emerged from the implementation of the project include:

- Tailoring the delivery of an essential skills program, such as Foundations, to shifting client demographics will lead to stronger outcomes.
- The addition of wrap around services to support learners is essential for retention, and these should be recognized as part of future contribution agreements for similar SIB projects.
- The pay for performance model designed for the college delivery providers proved to be an incentive, however, it was also viewed as an impediment too. The delivery providers communicated they felt added pressure to ensure the successful delivery of the Foundations program due to the potential loss of investor capital if reimbursement levels were not reached.
- In terms of participant recruitment, support in recruiting a large enough sample size to build a more robust economy of scale is vital for financial incentivization.
- College service delivery providers should receive training on informed consent and working with participants with anxiety.

Pay for performance social finance instruments are still relatively new and the next few iterations will continue to produce unique insights and opportunities for refinement and retooling. Given the evolving nature of social finance in Canada, investors in particular should be engaged early in the design phase of social finance projects to obtain a more accurate sense of their readiness and appetite for the offering overall. This will also permit input into particular features of the SIB being designed.