The Treasury

Social Bonds Information Release

Release Document April 2017

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Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

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<tr>
<td>[1]</td>
<td>to protect the privacy of natural persons, including deceased people</td>
<td>9(2)(a)</td>
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<td>[2]</td>
<td>to protect the commercial position of the person who supplied the information or who is the subject of the information</td>
<td>9(2)(b)(ii)</td>
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<td>[3]</td>
<td>that the information requested is or will soon be publicly available</td>
<td>18(d)</td>
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<td>[4]</td>
<td>to prevent the disclosure of official information for improper gain or improper advantage</td>
<td>9(2)(k)</td>
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Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [1] appearing where information has been withheld in a release document refers to section 9(2)(a).

In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) and section 18 of the Official Information Act.
Joint Report: Draft SOC paper on the first social bond

Date: 18 November 2016
Report No: T2016/2250
MOH Report No: 20161925
File Number: ST-5-4-2-1-1
AD62-14-2016

Action Sought

<table>
<thead>
<tr>
<th>Action Sought</th>
<th>Deadline</th>
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<tr>
<td>Minister of Finance (Hon Bill English) Review and provide comment on the</td>
<td>10am Thursday 24 November 2016</td>
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<tr>
<td>attached SOC paper and authorise for submission for SOC on 30 November.</td>
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<tr>
<td>Indicate whether you would like a briefing with officials.</td>
<td></td>
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Contact for Telephone Discussion (if required)

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
<th>Telephone</th>
<th>1st Contact</th>
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<tbody>
<tr>
<td>Carl Bakker</td>
<td>Social Bonds Programme Director, Ministry of</td>
<td>021 977 702</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>Health</td>
<td>(mob)</td>
<td></td>
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</table>

Actions for the Minister’s Office Staff (if required)

Return the report to Treasury and the Ministry.
Enclosure: Yes (attached)
Executive Summary

This report sets out the proposed arrangements for New Zealand’s first social bond, supporting better employment outcomes for beneficiaries with diagnosed mental health conditions. A draft Cabinet paper is attached for your review.

While the pilot programme has taken some time to get to this stage of a signed outcome agreement, it is now possible that service provision under the proposed bond arrangements could begin from 1 February 2017. This timing will ensure that job seekers with mental health conditions in the regions currently reserved for the bond (since July 2016) will be able to receive enhanced employment assistance services.

As advised previously, an expedited procurement process has been used to secure a potential social bond that offers improved employment outcomes for those with mental health conditions, following the withdrawal of the Wise Group and ANZ in May 2016.

The Social Bonds Pilot team in the Ministry of Health, working closely with The Treasury and Ministry of Social Development (MSD) officials, has now reached the position where APM Workcare Ltd (APMW) has made an offer for a social bond agreement. It would provide employment assistance for up to 1700 job seekers who have a diagnosed mental health condition, running over six years from 1 February 2017. The main referrals for the services would come from six MSD offices in Auckland, where these offices are not otherwise providing services for these clients under the general alternative contract, Work-to-Wellness (W2W) in anticipation of the social bond.

Overall this bond is relatively small and has been kept simple. It retains the core social bond elements of a genuine outcome contract where payments vary with the degree of success in reaching outcomes, and requires investors to manage the contract and provide finance, albeit with simplified structural arrangements. Investor returns on their bonds vary with the level of outcomes achieved, and the degree of risk assumed.

Total potential outcome payments under the bond are capped at $1.5m of bond investment is required (which principally provides the necessary working capital and is repaid over the duration of the bond). Investment is made in two tranches, $1.2m in less risky Class A and $300,000 in Class B. Once implemented, the outcome contract and payments will be administered by MSD.

The underlying outcome agreement has been negotiated by the Social Bonds Pilot team with input and support from Treasury and MSD officials. If agreed by Cabinet, the outcome agreement (where signature by the service provider is expected by end of 18 November) can be counter-signed, triggering issue of the bonds. Once capital is raised the service provider can proceed with services. Firm interest in 60% of the required finance has already been secured and the Social Bonds Pilot team are relatively confident the remainder can be secured. However, if capital is not raised then the contract will lapse and the bond will terminate.
Recommended Action

We recommend that you:

a  **review** and provide comment on the attached SOC paper and authorise for submission for SOC on 30 November.

   Agreed / Not agreed

b  **indicate** if you would like a briefing from officials.

   Yes / No

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Dan Marshall
**Acting Manager Commercial Operations,**
The Treasury

Fergus Welsh
**Group Manager, Financial Advice and Control,** Ministry of Health

Hon Bill English
**Minister of Finance**

Hon Dr Jonathan Coleman
**Minister of Health**
**Joint Report:** Draft SOC paper on the first New Zealand social bond

**Purpose of Report**

1. This report provides additional detail on the content of the attached SOC paper, the processes that have taken place, and comments on risks and other issues.

**The proposed social bond**

2. As advised previously, an expedited procurement process has been used to secure a potential social bond that offers improved employment outcomes for those with mental health conditions, following the withdrawal of the Wise Group and ANZ in May 2016.

3. The Social Bonds Pilot team in the Ministry of Health, working closely with Treasury and MSD, has now reached the position where APM Workcare Ltd (APMW) has made an offer for a bond agreement. It would provide employment assistance for up to 1700 job seekers who have a diagnosed mental health condition, running over six years from 1 February 2017. The main referrals for the services would come from six MSD offices in Auckland, where these offices are not otherwise providing services for these clients under the general alternative contract, Work-to-Wellness (W2W).

4. As set out in the SOC paper, APMW is a New Zealand registered company established in 2011, wholly owned by its Australian parent APM. APM is a credible supplier with a substantial track record of success in vocational employment services and rehabilitation in New Zealand, Australia, and more recently, the UK. APMW in New Zealand has grown rapidly, and now employs around 130 FTEs in New Zealand and won about [2] of W2W contracts recently tendered, as well as additional work with ACC and other government agencies.

5. Overall this bond is relatively small and has been kept simple. It retains the core social bond elements of a genuine outcome contract where payments vary with the degree of success in reaching outcomes, and requires investors to manage the contract and provide finance, albeit with simplified structural arrangements. Returns to investors vary with the level of outcomes achieved and the degree of risk assumed.

6. Total potential outcome payments under the bond are capped at [2] over six years, and $1.5m of bond investment is required (which principally provides the necessary working capital and is repaid over the duration of the bond). Investment is made in two tranches, $1.2m in less risky Class A and $300,000 in Class B. Once implemented, the outcome contract and payments will be administered by MSD.

**Key issues, risks and proposed mitigations**

*Outcome achievement and Crown benefits*

7. Both international and New Zealand research and experience suggests a strong correlation between suitable and consistent employment and improved mental health and wellbeing outcomes, evidence which also underpins other MSD initiatives such as W2W contracts. The bond is designed to deliver improved outcomes for jobseekers with mental health conditions and has clear measurement and payment metrics around some of these results – time spent off benefit and in work.
8. There are risks that employment may lead to worsened mental health outcomes in some cases. As this bond has payment metrics solely dependent on employment outcomes it is important to ensure any such risks are minimised and well managed, effectively implementing some form of “do no harm”. To achieve this, the outcome agreement initially included general principles of good practice and the service provider has provided reassurances that these situations would be identified, monitored and avoided. Following consultation with the Mental Health Directorate in the Ministry of Health (MoH), an additional safeguard has been added to the outcome agreement requiring that any enrolments need to identify the links with a GP. This provides a base degree of assurance that any obvious deterioration in a client’s mental health will be identified. Additional key data linkages (NHI, MSD client number, IRD numbers) are also required for each enrolment to enable longer term research and evaluation, but no detailed proposals for this have yet been developed.

9. The base case level of performance (being that level of performance at which the investors will earn the coupon return), an overall work placement rate of 43%, is based on the offer from the service provider and is derived from their previous experience. This target rate can be very favourably compared with a 10% placement without any intervention (the Counterfactual) and a target of 30% under the existing MSD contract for job seekers with mental health conditions, W2W.

10. The bond offers high rates of return to the Crown, even if performance is well below expectations, as only a small proportion of benefits accruing to the Crown (from reduced benefit payments and additional income tax, but above the levels achieved in the counterfactual) are paid to the service provider. At the base case or target level, the net present value of Crown benefits is about 5 times the full costs (including Crown administration). This result is relatively robust across differing performance levels. The bond also offers strong incentives for additional, and longer, work placements. While a full comparison with W2W is complex due to differing payment structures, overall the bond offers a better value outcome for the Crown and incentivises some innovation and high levels of performance.

Investment returns

11. The target rates of return for investors in the bond are broadly in line with similar performance contracts and PPP projects, however, it is inherently difficult to directly compare as each project (and bond) is based on the unique facts of the particular project and outcomes sought. The targeted rates of return (achievable on delivery of services under the outcome agreement to the required standard) are expected to be 7% for Class A (comparable to senior debt investors in other projects) and 13% for Class B (comparable to equity investors in other projects). Actual rates achieved will be dependent on the provider’s performance in delivering the outcomes but may vary between 3% and 9% for Class A, and -19% and 17% for Class B (that is to say that it is possible that investors in Class B may lose a portion of their capital as well as foregoing returns). These are set out below:

<table>
<thead>
<tr>
<th>Returns on the bond</th>
<th>Success rate- placements</th>
<th>26%</th>
<th>33%</th>
<th>35%</th>
<th>37%</th>
<th>39%</th>
<th>41%</th>
<th>45%</th>
<th>45%</th>
<th>47%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class A</td>
<td>2.9%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>8.3%</td>
<td>9%</td>
<td></td>
</tr>
<tr>
<td>Class B</td>
<td>-19%</td>
<td>-9.3%</td>
<td>-0.8%</td>
<td>4.9%</td>
<td>9.2%</td>
<td>13%</td>
<td>13%</td>
<td>16%</td>
<td>17%</td>
<td></td>
</tr>
<tr>
<td>Crown NPV benefits to cost ratio</td>
<td>2.7</td>
<td>3.8</td>
<td>4</td>
<td>4.3</td>
<td>4.5</td>
<td>4.8</td>
<td>5</td>
<td>5.4</td>
<td>5.7</td>
<td></td>
</tr>
</tbody>
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12. The minimum and maximum rates reflect agreements reached during the contract negotiations about management of risk and ensuring the development of a bond that was of interest to potential investors. Consistent with performance based contracts:
• the minimum has been set to allow the Crown and bondholders to terminate the bond if it was not working well for jobseekers and delivering the outcomes sought while still ensuring that investors felt some pain from poor performance; and

• maximum returns have been capped to preserve the value for money proposition to the Crown and safeguard the Crown from payment levels that may be perceived as supernormal and beyond a fair return for the risks taken. If returns are above the specified caps, the surplus is returned to the Crown at the end of the bond’s life. This feature has placed additional complexity into the contracting arrangements as the Crown is then required to monitor payments made from the service provider contract vehicle (a special purpose vehicle) to ensure any surplus is not passed through as increased payments to the service provider.

13. The Social Bonds Pilot team has helped APMW explore and broker potential investment. Given the size of investment, it is anticipated only three investors will be involved. Already APMW has indicated its interest in taking the entire Class B tranche (the most risky) which provides a tangible incentive to ensure the outcomes are delivered and represents a strong signal of their expectation of success. There has also been firm interest from another New Zealand based philanthropic fund/investor for half of Class A. The Social Bonds Pilot team is relatively confident the full investment can be raised in the time required although market interest is limited. The small size, the link to social outcomes where most investors have little experience, and the bond characteristics (a mixture of debt and equity) have meant that most fund managers are not prepared to seriously consider investing.

Contract administration

14. MSD have agreed to administer the outcome agreement, provided that funding is appropriated for costs associated with managing the outcome agreement. It is anticipated that an additional \[3\] will be required by MSD to employ specific personnel to monitor and manage this contract. It is also proposed in the Cabinet paper that \[3\] be set aside in a tagged contingency for a two part evaluation of this bond, with decision rights over this contingency delegated to Joint Ministers Finance and Social Development. We support these amounts as part of the full cost of establishing and running the bond and maximising the value of the pilot for possible future bonds. Treasury also is committed to working with MSD to provide ongoing governance of the bond contract.

Timing

15. The Social Bonds Pilot team has assurance that signature by the service provider will be provided by end of 18 November on a signed offer (outcome agreement). This will be executed by MSD if Cabinet agrees to the proposal. In turn this will allow APMW’s special purpose vehicle to formally issue the bonds, and seek investment before a final date of 30 January 2017.

16. While the pilot has taken some time to get to this stage of a signed offer (outcome agreement), it is now possible that service provision under the outcome agreement could commence as early as 1 February 2017. Consideration of the attached paper at SOC on 30 November 2016 would allow job seekers with mental health conditions in the regions currently reserved for the bond to receive employment services from early 2017.

Funding

17. A tagged contingency of $28.4m is held in Vote Finance for any social bonds. It is proposed that funding required for this bond, of \[3\] outcome payments (maximum)
and administrative costs of [3] are funded from this contingency and transferred into MSD appropriations. It is also proposed that a total of [3] for a two-stage evaluation of the bond be set aside in tagged contingency, with draw-down being contingent upon the agreement of the scope and plan for the evaluation. Details are set out in the SOC paper.

18. Funding for the administrative costs was not included in the $28.4m contingency fund when it was established in Budget 2015. This was calculated based on expected outcome payments for bonds 1 and 2 based on the modelling work that had been done at that time. It is possible that in funding these costs out of this contingency, there will not be sufficient funding for the outcome payments for bond 2, should that bond proceed to contract. However, the administrative costs are quite small in the context of the funds available, and there are likely to be options for scaling bond 2 should this become a practical issue.

Future bonds

19. The Social Bonds Pilot team is working on one further bond dealing with youth reoffending. Due to data complexities it is proving difficult to establish the potential outcome gains but we expect this work to be completed in the next month. If that identifies a strong case for continuing, additional complexities with regard to the consortium and the changing youth justice landscape will need to be considered before advice is provided on the merits of proceeding. Prospects for success seem low at this stage, which from a pilot perspective is disappointing as this bond would be a test of more complex structures and a larger investment requirement. The cross-agency steering group is proving very helpful in identifying issues and potential merits, and the Social Bonds Pilot team will provide an update on progress before Christmas.

Consultation

20. The Social Bonds Pilot team has led work developing the outcome agreement and associated documentation and arrangements. The Treasury has been closely involved, particularly in relation to commercial issues, together with MSD on more general contracting issues. All three agencies support the arrangements reached, and comments have been fully incorporated in the SOC paper. In addition, a senior level cross-agency steering group has been used to test judgements on key issues.

Communications

21. It is strongly suggested that any announcements in relation to this bond be deferred until it is known whether the full investment required can been raised (January 2017). This approach is consistent with the approach taken on similar projects, such as PPP procurement, where an announcement is deferred until after financial close. The outcome agreement requires that all media and public enquiries received by APMW about the bond must be notified to the Purchasing Agency (MSD) and responses consistent with an agreed communications plan.
Next steps

Timeline for lodging the paper

22. The attached Cabinet paper needs to be lodged with the Cabinet office by 10am Thursday 24 November, in order for it to make the agenda for the 30 November SOC meeting.