Financial innovation as a potential force for a positive social change: The challenging future of social impact bonds

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ABSTRACT

Since the last financial crisis, financial innovation has been called into question because it generated complex financial assets detached from economic reality. More precisely, the development of very abstract contracts ballooning subprime mortgage market would be at the origin of the last crisis. Financial creativity can produce severe consequences but it can also drive socio-economic changes favourable to the society. This article presents social impact bonds as a telling example of a financial innovation that could contribute to a significant improvement of society. These assets are used to fund social programs such as helping homeless people, rehabilitating prisoners or supporting early interventions with underprivileged people. By redesigning social programs through market-based solutions, SIBs enhanced transparency of expenditures made by government, they can help to stabilize economic activity and they can contribute to the self-realization of disadvantaged people. This reflexive paper reconsiders finance through the lens of the financial and ethical implications of these new assets. By combining usual aspects of finance with social welfare, social impact bonds imply new practices but also a new way of thinking the concept of return. This article aims at discussing these aspects.

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1. Introduction

Since the last financial crisis, some commentators (Baker, 2008; Johnson and Kwak, 2009 or Arestis and Karakitsos, 2009) called financial innovation into question: by favouring the development of very abstract financial assets, financial innovation would be at the origin of the last subprime crisis. However, despite financial creativity can indeed produce severe consequences when it is mismanaged (Shiller, 2008), it can also drive socio-economic changes favourable to the society. This reflexive paper will discuss this perspective by focusing on a very specific financial asset called “social impact bonds” (SIBs) which recently appeared as an innovative way of funding welfare issues.

For several years, financial innovation initiated the development of payment-by-result framework in which funded projects are supposed to generate social and financial benefits at the same time. That new incentivises all involved contractors with a conditional payment based on the completion of agreed outcomes. According to Whitfield (2011, p. 22), there exist two rewards models: phased incentive model and social impact bonds: while the first refers to a “standard outsourcing contract, with an incentivised payment mechanism (depending on the results)”, the latter rather provides a payment only if a specific target is reached. In other words, the first offer a proportional payment to the result whereas the social impact bonds

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provide a fixed payment conditional on the completion of agreed outputs. This paper will deal only with the second category of assets (SIBs) which appears to be a new form of financialisation transferring risk, responsibility to private individuals and reducing the scope of welfare state (Whitfield, 2011). More precisely, this article aims to explain that a well-managed SIB could drive social and economic changes contributing to what Shiller (2012) called a “good [financial] society”.

The first section will discuss the role of financial innovation which can also generate severe consequences when it is misunderstood or mismanaged as it was the case during the last subprime crisis. Afterwards, the second section will introduce the concept of social impact bonds while the third section will emphasize how these new assets could contribute to a good post-crisis society from a financial, economic and ethical perspective.

2. Financial innovation as source and solution for the financial crisis

The last three decades have been marked by a sharp and astonishing increase in the complexity of the financial reality. Simultaneously, we observe a phase of financial liberalization (in the 1980s and 1990s),1 an increasing phase of computerization of financial markets (since the 1980s, see Mackenzie, 2006) and an excessive liquidity (in 2000s) resulting from an easy monetary policy in Japan and US. This more and more complex financial sphere logically generated a growing sophistication of financial products. Allen and Yago (2010) listed more than 35 new financial products that have appeared recently. In consequence of this evolution, a prolific literature has emerged about financial innovation. Some authors try to understand and explain the financial innovation itself. Bettiʒüge et al. (2001), for instance, study the evolutionary dimension of the financial innovation by presenting the sophistication of the financial products as a result of the growing complexity of the investors’ needs whose an increasingly complex demand may be influenced by a multiplicity of factors such as changes in the financial regulation, macro-economic factors (interest rates, exchange rates, etc.) or changes in the taxation system. By satisfying the increasing complex needs of investors, the sophistication of financial products has allowed a personalization of the financial services (Fain and Roberts, 1997). In a sense, financial innovation can be considered as a way of democratizing the access to capital (Shiller, 2003; Allen and Yago, 2010). The financial innovation related to housing sector is a telling example of this democratizing process.

Encouraging homeownership is a welcome and laudable objective. However, by increasing the sophistication and the immateriality of assets, financial innovation can also contribute to the financial crisis when it is mismanaged. In the past, people with a poor credit history did simply not borrow in the mortgage market. The development of new collateralized debt obligations and securitized vehicles democratizing the access to credit led some authors (Johnson and Kwak, 2009) to claim that financial innovation was a significant actor of the last financial crisis. While securitization principles have been developed in the 1970 by the company GinnieMae (Fabozzi and Modigliani, 1992), Allen and Yago (2010) explained that the share of home mortgages that were securitized increased dramatically from 11% in 1980 to 60% in 2008. Mortgage market become very important whereas these contracts have progressively been associated by portfolio managers with classical financial products likely to diversify their specific risk. In parallel, complex mortgage products have been developed to meet a more and more specific demand: from CDOs to CDS of CDOs or CDOs of CDOs, banks associated mortgages with more and more complex structured investment vehicles within a simple legal structure requiring a small capital base.

This increasing complexity of these mortgage products led to the emergence of predatory practices convincing people with a poor credit profile to borrow on the mortgage market (Shiller, 2008). Basically, the implicit assumption behind the securitization of mortgages was that the price of house will never fall. In this perspective, borrowers and lenders could benefit from this appreciation of house prices – since the first would finally be able to finance and refinance their homes thanks to the capital gains resulting from the house price appreciation. Given this assumption, Mortgage originators invited people with a poor credit profile to borrow in a “ballooning subprime mortgage market” (Shiller, 2008, p. 13) whose refinancing was supposed to be ensured by an hypothetical appreciation of house prices; and whose the repayment risk was diluted by mortgages securitizers. Consequently, the economic (real) value of these agreements was over-estimated for two reasons: (1) the implicit assumption behind the securitization of mortgages was that the price of house will never fall; and (2) securitization offered the theoretical certainty that diversification will dilute the real economic risk associated with the worst agreements. This securitization process favoured the packaging, the sale and the resale of mortgages in sophisticated vehicles worldly distributed which led to a global crisis.

Although financial innovation contributed to the emergence of subprime crisis that would be a mistake to think that one should return to yesterday’s simpler financial assets. Indeed, this crisis seeds of changes by initiating an opportunity to rethink and improve our financial practices, as Shiller (2008) mentioned it,

“This subprime crisis has set in motion fundamental societal changes – changes that affect our consumer habits, our values, our relatedness to each other […] the social fabric is indeed at risk and should be central to our attention as we respond to the subprime crisis” (Shiller, 2008, p. 9).

It is time to take fundamental steps in order to restructure and reconsider our way of thinking the role of finance in our society. In accordance with Shiller’s words, social impact bonds are a telling example of a financial innovation which could

1 For further information about this process, see Stiglitz (2000) or Wurgler (2000).
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