

DEVELOPMENT IMPACT BONDS

WORKING GROUP BRIEFING NOTE

MEETING I - 29 MAY 2012

Background

A Social Impact Bond (SIB) is a payment for outcomes model that seeks to shift attention, incentives and accountability to results; transfer risk and responsibility for performance to private investors and implementers; and drive value for money and efficiency gains throughout the cycle.

A Development Impact Bond is a potential variation of the SIB model that would provide new sources of financing to achieve improved social outcomes in developing country contexts. As with SIBs, investors would provide external financing and only receive a return if pre-agreed outcomes are achieved. Funds to remunerate investors would come from donors, the budget of the host country, or a combination of the two. Financial returns to investors are intended to be commensurate with the level of success. This approach is intended to strengthen incentives for the innovation and adaptation necessary to deliver successful outcomes.

This briefing note describes the structure of Social Impact Bonds being piloted in developed countries, and factors to consider in adapting the idea to international development.

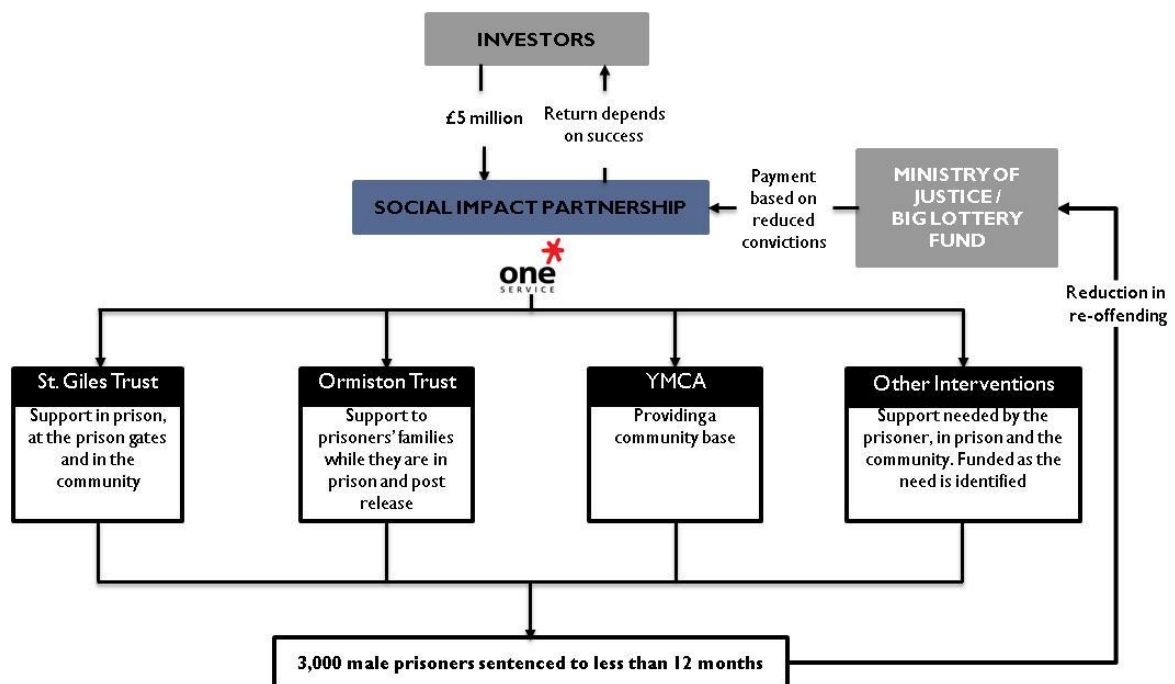
Introduction to Social Impact Bonds

Social Impact Bonds are a family of outcomes-based financing products in which social investors fully or partly pay for services to be delivered that improve social outcomes and the effectiveness of public sector spending.

The first Social Impact Bond was developed by Social Finance with the UK Ministry of Justice and was officially launched in September 2010. Social Finance raised £5m from 17 social investors to fund work with 3,000 short-sentence male prisoners leaving Peterborough prison.

Payments are made in proportion to the programme's success at reducing offending among the prison leavers; investors in the Peterborough SIB receive a financial return on their investment upon independent verification that the interventions they funded were successful. SIB investment is not intended to displace other funding, but to supplement the money available to pay for a wider range of interventions than service users currently receive.

A simplified illustration of the Peterborough Social Impact Bond structure is shown below:



Social Impact Bonds were designed to respond to growing recognition that some services should be bought on an outcomes basis. Focusing accountability on inputs, processes and price had tended to produce inflexible, 'one size fits all' services. At the same time other service areas, particularly early intervention and prevention activities, had a poor record of being purchased at all.

By developing Social Impact Bonds we aimed to solve two issues that payment by results approaches create:

- Service providers often need to wait to get paid – typically longer than they can afford; and
- Service providers can usually only provide part of the solution and are therefore dependent on others to get paid.

Social Impact Bonds resolve these issues by bringing in third party investment to take the risk and enable a coordinated response across service providers. They provide a low risk route for government to test social innovation or to transfer the risk of service roll-out.

Since the launch of the Peterborough Social Impact Bond, Social Finance has explored the potential to use outcomes-based finance to support a wide range of outcomes for target populations with complex needs. These include rough sleepers, looked-after children, people with chronic health conditions, substance users and disadvantaged young people with poor employment prospects. Social Impact Bonds have generated considerable interest from governments in a range of more developed countries including the US, Canada, Australia, Ireland and Israel.

At least some of this interest has been motivated by a need to make cost savings in the light of increasing budgetary pressure. As a result many of the SIB applications being explored in more developed countries are focused on outcomes that would enable a shift away from 'treatment'



services – like prisons and hospitals – by providing more funding for earlier interventions to prevent problems – such as community healthcare and behaviour change programmes.

Social Impact Bonds also have value as a mechanism to improve the effectiveness of existing spending in locations or social issue areas where the interventions that will achieve maximum impact are poorly understood, or where there is considerable variation in the quality of implementation.

The case for Development Impact Bonds (DIBs)

DIBs can provide new sources of financing from private investors to improve social outcomes in poor countries. Public sector entities, including the governments of developing countries and donors engaged in those countries, face many of the same problems that the SIB model was responding to in developed countries: a focus on inputs and processes means that the delivery of social services is often heavily bureaucratic, and there is insufficient evidence around which interventions actually work.

Designing a DIB structure would involve many of the same considerations that went into the development of SIBs, with additional considerations for the challenges posed by developing country contexts. Multiple variations are possible although the basic structure is that, if evidence shows that social outcomes have improved, then investors would be remunerated with a return by donor agencies and, where resources exist, by host country governments.

While DIBs are not limited to models that involve the use of donor funds, DIBs represent a potential solution to additional problems with the aid system. These problems include:

- A lack of transparency and poor measurement of development outcomes mean that too little is known about what aid spending has achieved;
- Coordination is poor among aid agencies and other public and private entities that provide foreign assistance, meaning that efforts are fragmented, frequently duplicative and leave gaps; and
- Governments' accountability to foreign funders might undermine the process by which countries develop their own institutions.

DIBs have the potential to improve aid efficiency and cost-effectiveness by shifting the focus onto implementation quality and the delivery of successful results. Compared to traditional approaches to aid, DIBs offer several benefits, including:

- Creating incentives to focus on achieving and measuring outcomes;
- Enabling donors to fund outcomes while leaving flexibility for service providers to experiment to find solutions that work;
- Leveraging support of the private sector to increase innovation and efficiency in service delivery
- Creating mechanisms for coordinating government, private sector investors and non-government service providers;
- Transferring risk from public sector to enable earlier intervention and innovation; and



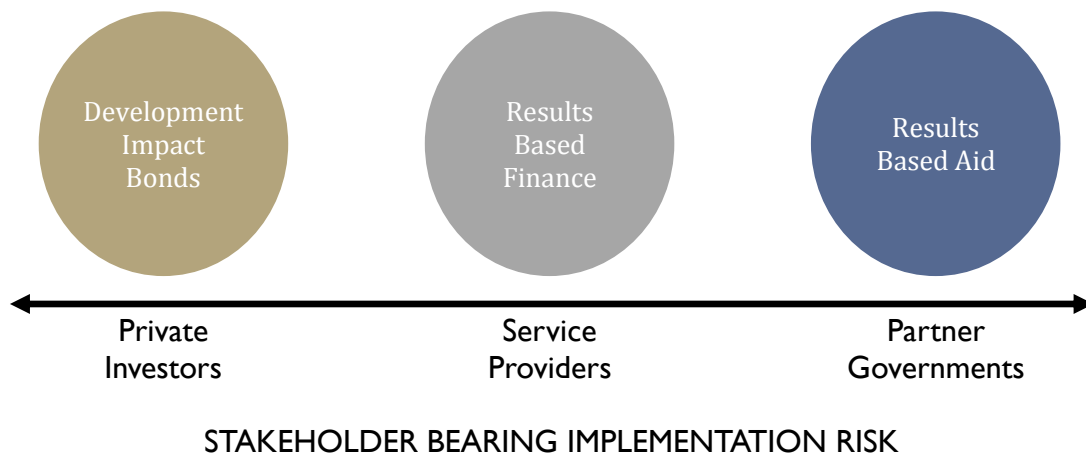
- Providing upfront funding to service providers enabling them to more easily participate in results-based contracts.

Development Impact Bonds could also be used to improve partner government capacity to manage contracts, develop robust data systems and scale-up successful programmes. Depending on the country, there is potential for partner governments to co-fund outcomes payments with donor agencies and/or co-commission and contract-manage.

Challenges with how aid is working to date, combined with the financial crisis and budgetary pressures, have heightened the pressure on aid agencies to demonstrate clear evidence of results. DIBs could be an additional mechanism for results-based approaches which donor agencies are increasingly exploring as a way to respond to these challenges.

Existing results-based approaches include *results-based finance (RBF)*, which involves contracts between the funder and service providers, and *results-based aid (RBA)*, which involves an aid relationship between a funder and recipient country government. RBF and RBA approaches can take many forms, but Development Impact Bonds may help to address two particular concerns about current applications of these approaches: (1) uncertainty about where upfront funding for interventions will come from; and (2) concerns that service providers or recipient country governments will not be able to bear implementation risk – the risk that funded interventions don’t deliver the desired impact. In the case of DIBs, upfront funding, and hence implementation risk, is provided by private investors.

The diagram below shows the stakeholder bearing the majority of the implementation risk within different types of results-based contracts in development.



DIBs could take the risk of achieving outcomes away from either service providers or partner governments. The table below shows a summary comparison of the features of Development Impact Bonds against results based aid and results based finance approaches.



Consideration	Results based aid	Results based finance	DIB
Clear role for partner government	✓		
Potential to implement without partner government involvement		✓	✓
Clear role for private investors			✓
Clear source of upfront funding for services			✓
High-level focus on outcomes	✓		✓
Independent verification of results required			✓
Risk borne by service provider (government or non-government)	✓	✓	
Complementary to existing approaches	✓	✓	✓

The DIB model has potential as an approach to funding interventions that will improve development outcomes. However, it is unclear whether and where the approach may be more effective than alternative forms of development finance, and what guidelines for the development of a DIB structure may be.

A number of factors should be taken into account when developing Development Impact Bonds, some of which apply to all Social Impact Bond models and others which are unique to the model for development. A preliminary list of considerations is outlined in the table below.

Consideration	
Role of partner government	<ul style="list-style-type: none"> • Potential roles of partner governments include: <ul style="list-style-type: none"> ○ Co-commissioner / contract manager ○ Funder / co-funder of outcome payments • Potential for partner government involvement in service provision dependent on investor confidence in delivery capacity • Perception of partner government credit rating by investors a consideration if outcome funder



Consideration

Payment metrics

- Availability of data to create baseline and track progress
- Sensitivity of metric to DIB-funded interventions
- Avoidance of perverse incentives
- Potential for independent verification

Value for money

- Balance between sufficient evidence of what works to attract investors, and sufficient variation in implementation quality to justify risk transfer
- Service provider working capital requirement to deliver to PBR contracts
- Value for money likely to result from optimum rather than maximum risk transfer due to cost-of-capital considerations
- Appropriate balance between outcome and output payments likely to be determined by nature of required interventions
- Careful thought required to value outcomes when not linked to cashable savings

Investor interest

- Likely to be determined by a combination of social issue, geography, level of risk transfer and implementation approach
- Some element of capital guarantee may be required to raise substantial sums
- Risk appetite may increase over time with experience and opportunities for diversification

Working Group Objectives

The CGD/Social Finance Development Impact Bond Working Group will assess the Development Impact Bond model as a new approach to development finance. During the first meeting, the group will consider the factors outlined above to articulate key principles that should guide the use of DIB structures to ensure that the model is a useful tool for international development.

The group will discuss examples of applications of the DIB model and, in subsequent meetings, will explore a small number of practical opportunities in further detail, with a view to developing an action plan for a pilot of 2-3 DIBs in 2013.

Key discussion points – Meeting 1

- Which principles should drive the use of Development Impact Bonds?
- Where do you see promising opportunities for applying Development Impact Bonds in terms of issue areas and geographies?
- How might promising opportunities be prioritised?



Appendix 1 – Working Group Members

Name		Role	Organisation
Bob	Annibale	Global Director, Citi Microfinance and Community Development	Citigroup
Owen	Barder	Senior Fellow and Director for Europe	Center for Global Development
Vineet	Bewtra	Director, Investments in Government Transparency	Omidyar Network
Nancy	Birdsall	President	Center for Global Development
Toby	Eccles	Development Director	Social Finance UK
Chris	Egerton Warburton	Partner	Lion's Head Capital Partners
Rebecca	Endean	Director Analytical Services	Ministry of Justice, UK
Stefan	Isaksson	Senior Advisor, Department for Global Cooperation	SIDA
Kippy	Joseph	Associate Director, Innovation	Rockefeller Foundation
Dan	Kress	Deputy Director and Chief Economist, Policy Analysis and Financing	Bill & Melinda Gates Foundation
Elizabeth	Littlefield	President & CEO	OPIC
Susan	McAdams	Director, Multilateral Trusteeship & Innovative Financing	World Bank
Steve	Pierce	Special Coordinator for Development Effectiveness	USAID
Oliver	Sabot	Executive Vice President for Global Programs	CHAI
Sonal	Shah	Board Member Social Finance US	Independent
Smita	Singh		Independent
Rachel	Turner	Director International Financial Division	DfID
Peter	Wheeler	Board Member Social Finance UK	Independent