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DEVELOPMENT IMPACT BONDS: BRINGING A PRIVATE SECTOR APPROACH TO PUBLIC GOODS

Background

Development funders are increasingly looking for ways to ensure that development assistance has measurable impact. One widely used approach is results-based funding, which creates incentives to achieve outcomes and not only delivery of inputs. In theory, a results-based approach frees service providers from having to implement pre-determined plans and allows them to focus on adapting programmes to achieve outcomes.

In practice, however, it has been challenging for donors and governments to provide this flexibility. Often, results-based approaches fine-tune implementation of an already structured programme rather than improving the programme structure itself. Under the traditional results-based approach this can be hard to avoid: the working capital for programme implementation often comes from the service providers themselves and funders see programme design as being outside the providers' remit or capacity. To limit risk to themselves and providers, funders define implementation models in advance. This means that, under traditional models, results-based funding has not reached its potential to provide a new and more effective approach to delivering outcomes.

A new approach to development finance

In light of these limitations, Social Finance has developed, with the Center for Global Development, the Development Impact Bond (DIB) model.[1] In a DIB, private investors provide pre-financing and work with a DIB Manager and delivery organisations to ensure that the results are achieved efficiently and effectively. Donors guarantee payments to investors if, and only if, the interventions succeed in achieving independently assessed results. Returns to investors are linked to the extent to which agreed results are achieved. In this sense, DIBs are like other forms of results-based aid, except with the addition of up-front external working capital to ensure finance at affordable rates for service providers.

Solving the pre-financing needs of service providers through private investment enables donors to focus a greater portion of payments on outcomes. This in turn creates flexibility to move away from input or activity based monitoring. The contractual scope for service adaptation to varied and changing local needs, through rapid feedback loops, is a key strength of the Impact Bond model and, in turn, should drive the best possible social outcomes.

Bringing investor dynamism to development aid

Private investors expect that any project or programme will need to be continuously revised to reflect learnings about what works and what doesn't, and to reflect changes in the operating environment. Accordingly investors give a DIB manager the latitude to make necessary changes quickly and efficiently.

This model of continuous improvement requires intensive, real-time data collection to create the necessary feedback loops. DIBs are designed to use modern techniques of rapid data collection and analysis. The DIB operational model allows for adaptive, data-driven operational management that can respond quickly as lessons are learnt during implementation. For

[1] *Investing in Social Outcomes: Development Impact Bonds*. Report of the Development Impact Bond Working Group. Center for Global Development and Social Finance, 2013.

example, for a DIB pilot to reduce sleeping sickness in Uganda, Social Finance used a smartphone app to collect and analyse real time data on cattle spraying and injections to understand if a mass treatment programme successfully reduces parasite prevalence. This data would feedback on a daily basis into improving implementation. (See page 3 for a typical DIB structure.)

Building a market for Development Impact Bonds

Impact Bonds in developed economies – called Social Impact Bonds (SIBs)[2] – have taken off rapidly since Social Finance launched the first SIB for reducing recidivism in Peterborough in the UK in 2010. More than fifty Social Impact Bonds, with a total of more than $180m in investment, have now been launched and there are at least 100 more under development. Experience to date with Impact Bonds shows that investors expect and obtain:

- Intensive collection and analysis of real-time data;
- Performance management that responds quickly to such analysis;
- Flexibility to adjust programme structures as needed, constrained only by compliance with fiduciary safeguards (i.e. environmental, social and anti-corruption safeguards).

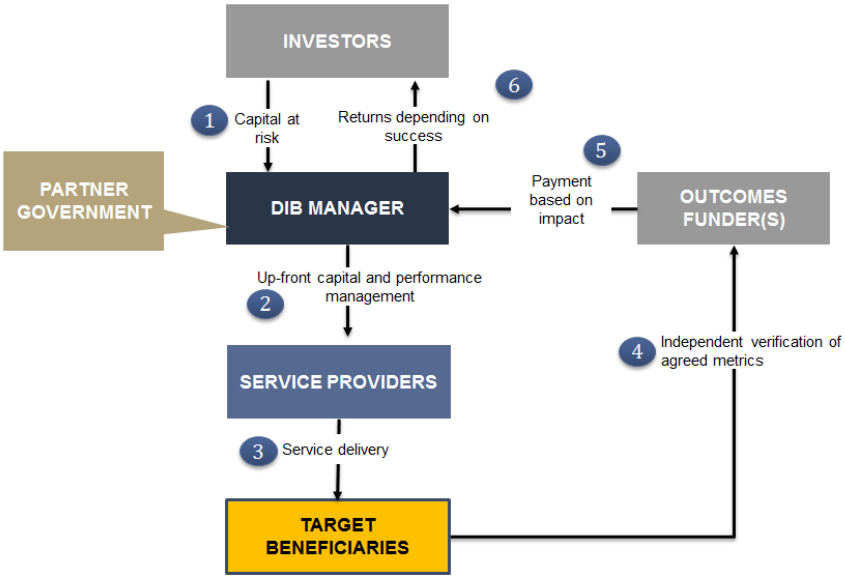
Building on the success of developed economy SIBs, Social Finance and others have been expanding the market to low and middle-income countries. Impact bonds are being explored to improve funding impact in a range of issue areas – including health (including HIV, sleeping sickness and neonatal health), education and employment – and a range of geographies including Latin America, Africa and South Asia. Social Finance is working with The Global Fund, World Bank, Grand Challenges Canada, USAID and others to improve funding impact through outcomes-based structures. Pooled outcomes-based funding vehicles ('Outcomes Funds') are also under development, reflecting an ambition of the market to achieve economies of scale and bring together multiple stakeholders.

[2] The term "SIB" is used where a domestic entity (typically a government) is the majority outcome funder, whereas "DIB" is used where an external donor funds the majority share. Impact Bonds are also known as 'Pay for Success' or 'Social Benefit' Bonds in the US and Australia respectively.

Typical DIB Structure

A Development Impact Bond brings together investors and outcomes funders to finance a programme that aims to achieve outcomes. The key actors are:

- ***Outcomes funders*** repay investors if – and only if – the programme succeeds in delivering agreed outputs and outcomes. The outcomes funder and partner government (if different) set the fiduciary guidelines that the programme must adhere to, but otherwise do not dictate programme delivery. The Outcomes Funder is regularly informed of progress by the DIB manager. The outcomes funder is unconditionally committed only to paying for independently verified, agreed results.
- ***Investors*** provide pre-financing to cover all DIB costs except independent verification. Since outcomes funders only make payments if agreed results are achieved, investors bear the risk of failure. The alignment of investors' financial returns to the achievement of results means that there is a strong incentive for investors to support effective performance management to oversee the DIB on a day-to-day basis.



- ***Partner governments*** have a range of possible roles in a DIB. In most cases, governments would work from the outset with outcomes funders and other DIB partners to define the target population and success metrics. Depending on resources available, some governments could be co-outcomes funders along with donors. Governments are also likely to have a role in overseeing contracts with private providers. DIBs could be a way to improve government capacity to implement outcomes-based contracts, develop robust data systems and scale up successful programmes.
- ***The DIB Manager*** oversees the delivery of agreed outputs and outcomes, and liaises with investors. The DIB manager analyses service delivery and output/outcome data continuously, and guides the work of the service providers accordingly, including shifting resources as needed. The manager is typically remunerated by investors via an annual fixed fee for service alongside a performance-related fee. The DIB manager may also charge a capital raising fee to DIB investors (as a percentage of total committed capital) which is paid on draw down.
- ***Service Providers*** deliver the intervention, with a principal service provider potentially playing a day-to-day coordinating role. While it is possible to have only one service provider, the type of complex delivery problem which DIBs normally address is best tackled by multiple service providers working together. In this way DIBs offer a multi-dimensional approach to solving complex development challenges. A clear advantage to service providers of the DIB model is that they receive necessary project financing in advance from investors.