

The Case for Development Impact Bonds

Inquiry into the role
of the private
sector in promoting
economic growth
and reducing
poverty in the Indo-
Pacific region

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1 The need for a new type of aid

Changing aid financing context

The way development is financed is rapidly changing. As domestic revenues (e.g. linked to stronger taxation systems), remittances, emerging donors (e.g. China), and private investment flows increase to developing countries, the relative importance of and demand for official public aid from traditional donors is diminishing. A significant challenge for these donors is to determine how their support can be used to catalyse and complement these other funding sources.

Limitations of current aid practices

Aid is complex and ever-evolving. In this context, there is much we can learn from the private sector. Successful private sector entrepreneurialism is characterised by the need to: be outcome-focused; recognise there are multiple pathways to achieving successful outcomes, and what works in one place and time may fail in another; experiment and innovate, opening new more efficient/effective pathways to success; acknowledge failure as an acceptable condition of success, provided it is learned from; and to ensure learning occurs 'real time', allowing entrepreneurs to respond quickly and adapt. Current aid delivery mechanisms stifle private sector innovation due to a culture of risk-aversion (fear of failure) resulting in highly prescriptive and inflexible designs/contracts, with few incentives for the private sector to innovate and provide new, cost-effective solutions to achieving development outcomes (as opposed to contractual compliance).

2 The response: new aid financing / delivery modalities

There is merit in considering new ways to engage the private sector in the delivery of aid in order to:

- > harness private capital as a source of sustainable and scalable development funding, ensuring an acceptable risk/reward tradeoff to attract private sector financiers to this new 'market';
- > benefit from private sector ideas, incentives and entrepreneurialism;
- > develop broader partnerships that bring business, government and civil society together and maximise the respective strengths of these stakeholders; and
- > promote better value-for-money for aid, through securing more efficient, effective and economical results.

A number of donors have started to reflect and act upon these ideas, and are increasingly trialing:

- > new payment structures that prioritise accountability towards achieving outcomes, such as cash-on-delivery aid¹;
- > new private sector aid financing mechanisms that help bring development solutions to scale, notably public-private partnerships²; and
- > innovative techniques combining a) and b) above such as Development Impact Bonds (DIBs) – discussed further below.

¹ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/49552/dfid-pilots-payments-results.pdf

² <https://www.gov.uk/private-infrastructure-development-group-pidg>

3 The Development Impact Bond model

A Development Impact Bond (DIB) is an outcomes-based contract whereby private investors provide upfront funding for social development interventions and are remunerated by public sector agencies at a commercial rate of return if evidence shows that the intended outcomes were achieved. Typically, key actors would include:

- > Private investors who provide up-front funds to roll out or scale up services, and assume performance risk;
- > Implementing agencies, i.e. private and / or civil society service providers, who work to design and deliver outcomes;
- > Outcome funders, primarily donor / public sector or philanthropic agencies who pay for the achievement of pre-defined results; and
- > Intermediary organisations who play the role of bringing together these actors, coordinating them across the design and implementation phases, and ensuring outcomes are rigorously verified.

Key characteristics

Key characteristics of DIBs include:

- > Outcome funders specify outcomes to be reached, not interventions – strategies for achieving outcomes are agreed between investors and service providers, usually through an intermediary, with flexibility for adaptation during the program.
- > Contract outcomes are independently verified as the basis for releasing payments from outcome funders to investors.
- > Outcome funders must be prepared to pay a ‘premium’ to attract private investors who – as for all private sector investments – will need to compare the relative risk/reward with other possible investments.

To date, there is limited but growing evidence to demonstrate the feasibility of DIBs. DIBs are in fact an adaptation of Social Impact Bonds (SIBs), which have been trialed for some time in developed countries. SIBs use domestic government revenues rather than foreign donor funds to pay for outcomes achieved – this is important to note as the model is equally applicable in developed, middle income (where the majority of the world’s poor now reside, but have largely graduated from donor funding), and lesser developed countries.

DFID have made a formal commitment to pilot DIBs³, with a £1.5 million inception project to design a bond structure to raise / reward private finance for tackling sleeping sickness in Uganda already underway. DFID is also committed to setting up an online ‘open source’ knowledge platform to share lessons from DIB pilots. The Centre for Global Development has also been facilitating a multi-donor funded DIB Working Group with a similar aim of exploring the efficacy of DIBs and fostering the establishment of a ‘DIB market’⁴.

³ Refer p.11 of http://effectivecooperation.org/wordpress/wp-content/uploads/2014/04/ENG_FinalConsensusMexicoHLMCommunique.pdf

⁴ <http://international.cgdev.org/page/development-impact-bonds-working-group>

Advantages

Perceived **advantages** of DIBs / SIBs – and the reason that many governments and donors are exploring them – are:

- > **Outcomes focus:** DIBs generate a culture of results, together with rigorous measurement and evidence-based monitoring and evaluation practices. The payment mechanism ensures governments / donors (funders) only pay when outcomes are achieved, satisfying public expectation of accountability of taxpayer funds.
- > **Value-for-money:** DIBs are one of the few aid delivery mechanisms based on the concept of value-for-money. In a healthy DIB market, different investors / implementers will offer different approaches to secure set outcomes, all at competitive market rates. The only constant is the result which is set by the donor (funder) who can then clearly establish the value-for-money proposition of each offer.
- > **Leverage and market discipline:** DIB have the ability to leverage private investment and take development solutions (sustainably) to scale. In parallel, they bring market discipline to aid: investors are unlikely to back strategies that can't demonstrate success.
- > **Administrative simplicity:** DIBs are administratively easier for governments/donors – they can be 'hands-off' in terms of how results are achieved.
- > **Tailored incentive structures:** Governments / donors transfer risk to the private sector, albeit at a commercial rate of return likely higher than the rates that apply under the more usual risk sharing model. The risk sharing profile of each DIB varies according to the nature and magnitude of the outcome to be reached, and the reward structure would vary accordingly.
- > **Innovation and agility:** Providing up-front funding while using a results-based contract means that implementers have flexibility to decide how to achieve outcomes, creating incentives to experiment, innovate and learn from failure, adapt iteratively without contractual constraints of pre-determined processes and outputs.
- > **Flexibility of application:** The mechanism is equally applicable in developed, middle income, and lesser developed countries.

Limitations

Possible **limitations** of DIBs / SIBs that will need to be addressed include:

- > **The (current) lack of a DIB market:** Who will invest from the private sector? While the model will likely attract 'social impact investors' that are more socially than financially motivated, to be sustainable and scalable the model must attract private capital by competing with other investments. The ability to do so will depend on (amongst other things): the financial 'attractiveness' of the market; the brokering role of the intermediary to identify investors and bring them together with service providers and funders; and the confidence that investors have in the efficacy of the DIB mechanism. The next three points below are all critical aspects of creating investor confidence/certainty.
- > **Pricing:** The DIB model relies on funders' ability to ensure outcomes are valued at commercial prices that do not exceed the value society places on achieving those outcomes. Until there is a body of DIB price precedents/benchmarks, it is likely this value will need to be negotiated with potential investors, using one or more of the following approaches: cost plus pricing; historical valuation; cashable benefits; or quantified social value, or via tender.⁵

⁵ Pp.77-79, Investing in Social Outcomes: Development Impact Bonds, Centre for Global Development, October 2013.

- > **Risk / reward structure:** The DIB model relies on partners to agree on an appropriate risk-return profile that weighs up factors such as the type and amount of risk; the investment term, liquidity and size; outputs vs. outcomes.⁶
- > **Outcome measurement:** the DIB model relies on the definition of clear and measurable outcomes. It requires robust M&E strategies that produce undisputable evidence of results (that will trigger payment). This is difficult to do under any development modality and requires an independent and rigorous verification process. It is of heightened importance under the DIB model given the clear link between payments and results.⁷
- > **Role of the partner government:** Integrating host government counterparts into the approach and process to ensure flexibility in implementation and development of a mature market for development outcomes. Host government counterparts may be reluctant to support the DIB process due to its need for flexible implementation strategies which will likely include authorisation for locations and activities from different entities in the host country.

4 A way forward for DIB

The emergence of DIBs is timely in that they have the potential to be a highly effective tool for DFAT to pursue its 'new development paradigm' that involves 'new kinds of partnerships between the private sector and the government' that bring 'innovative approaches, and different business models, which may provide solutions for otherwise intractable development challenges', as well as 'recognising the changing source of finance for development'.⁸

Suggested next steps for DFAT in exploring the use of DIBs within its aid program are to:

1. Become actively engaged in the growing international DIB 'community' – including representation on the Centre for Global Development DIB Working Group – to ensure a joint donor understanding of and application of DIBs.
2. Conduct scoping work to develop a framework concept note to:
 - > identify and assess opportunities based on development objectives, target countries and potential locations; and
 - > develop a core model which outlines operational and financial relationships among contributing partners and means of outcome verification.
3. Commission some small-scale DIB pilots under existing DFAT facilities (based on the opportunities identified in the initial scoping work).
4. Feed lessons learned back into the donor DIB discussion via the DIB Working Group and / or the DFID 'open source' knowledge platform (once established)

⁶ Pp.79-85, Investing in Social Outcomes: Development Impact Bonds, Centre for Global Development, October 2013.

⁷ Pp.72-76, Investing in Social Outcomes: Development Impact Bonds, Centre for Global Development, October 2013.

⁸ http://www.foreignminister.gov.au/speeches/Pages/2014/jb_mr_140429.aspx



About Cardno Emerging Markets

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