Center for Global Development

SOCIAL FINANCE

Investing in Social Outcomes: Development Impact Bonds

Summary Report of the Development Impact Bond Working Group

CONTENTS

Summary

There is a revolution in development finance. Private financial flows are growing, and developing countries are increasingly financing their own public services with domestic revenues. Finance from abroad is becoming more diverse, with new development partners, development finance institutions, philanthropic organisations and private investors working alongside traditional donor agencies. These new sources of finance and expertise increasingly complement the offerings of traditional development cooperation. This creates opportunities for new forms of partnership which can leverage the best that each has to offer.

Impact investing – that is, investment intended to create a positive social impact as well as a financial return – has already begun to channel private sector capital and expertise into generating social benefit in richer countries. But it is early days for this kind of investment, particularly as a contribution to development finance. This report explains how Development Impact Bonds (DIBs) can enable more impact investment in development, by providing a shared platform for governments, donors, investors, firms and civil society to work together, achieving more in partnership than any of them could achieve separately.

Development Impact Bonds are a variation on Social Impact Bonds (SIBs), which have been implemented in the UK, the US, and other industrialised countries to facilitate impact investment. The first SIB was launched by Social Finance UK at Peterborough Prison in 2010, and it is showing how improved results can be achieved (in this case, reductions in reoffending) by orienting programmes toward outcomes and creating a space in which public services can make better use of evidence, innovation and adaptation.

The principles are the same for SIBs and DIBs. All partners agree on a common goal and a way to measure success. Private investors finance a programme aimed at achieving these agreed outcomes. They work with service providers – which can be any combination of public agencies, private companies and non-profits – to manage delivery and create space for innovation and learning. If the programme is successful – confirmed by independently-verified evidence – then the 'outcomes funder' (usually a public sector agency) repays the investors. In general, the more successful the programme, the greater the return to investors, perhaps up to some cap. At the centre of these arrangements there is usually an intermediary organisation which coordinates among the investors, the service providers and the outcomes funders, and puts together a deal to fit all their needs.

These approaches depend on joining together programmes – that need flexible risk capital to get off the ground – with investors, who want to use their resources (including their money, skills and expertise) to make a social impact. The investors are not passive sources of money: they have skin in the game, and so have reason to pursue innovation and excellence to drive better results. Early schemes are likely to depend on investors who are motivated as much by social impact as by commercial return; but as experience with these instruments grows, and the opportunities for investment diversify, they may attract a wider range of more mainstream investment capital.

In many developing countries, there may not yet be enough domestic revenues for the government to meet all of the outcomes payments, even though the investments would be worthwhile. A distinguishing feature of a DIB is that some or all of the outcome payments are provided by an external funder, such as a development agency or charitable foundation.

DIBs draw inspiration from recent efforts of donor agencies to experiment with results-based funding approaches, which build in a more rigorous focus on programme outcomes, and more flexibility for solutions to evolve and local actors to innovate. They are more than a new way to attract funding for development; they are a new business model for development programmes, designed to encourage the innovation and flexibility for better results that are often stymied by the limitations of government budgeting, contracting and performance management.

For example, a DIB could be used to attract finance for and improve the services offered by Business Development Service providers in developing countries (as outlined in Case Study 5, p. 62, of the report). Donors are often interested in supporting business development for small and medium enterprises to boost incomes and jobs, and help build more vibrant economies. But these approaches have often not proven successful. If donors agree to finance a DIB, then investors could provide the initial funding and manage the innovation needed to develop successful models for these services, knowing that they will be repaid by donors to the extent that they succeed.

DIBs are not intended to be a solution to all problems in development, but in some cases may offer a number of advantages over existing funding mechanisms. DIBs can raise money for worthwhile social investments in developing countries, improve the effectiveness of public service delivery, and improve the efficiency of aid spending. They may be attractive for donor agencies that want to enter into new partnerships to ensure that aid is catalysing and complementing other financial flows and meeting the growing demand to demonstrate effectiveness against rigorously-defined and measured outcomes, while also respecting the complexity and unpredictability of delivery and the need for adaptation and flexibility.

This approach offers potential advantages in the following ways:

- DIBs transform social problems into “investible” opportunities by monetizing the benefits of tackling social problems, so attracting private sector investors wanting to bring their resources and skills to development.
- DIBs create incentives for investors to put in place (typically through intermediaries) the necessary feedback loops, data collection and performance management systems required to achieve desired outcomes, resulting in a bottom-up, client-centred, and generally more effective, approach to service delivery.
- Because investors provide funding - and assume risk - for interventions expected to lead to improved social outcomes, DIBs could attract funding for interventions that donor agencies and governments might not be willing or able to fund directly.

DIBs are a new approach and, at first it will take time, resources and new skills and expertise to develop them. To ensure that initial DIB pilots get off the ground and to help stimulate a market for this approach, the Working Group makes the following general recommendations (see pp. 9–15 for detailed recommendations):

- Donors should establish a **DIB Outcomes Fund** and investors should establish DIB Investment Funds, which would enable these actors to share risks and **pilot a range of DIB models**.
- DIB parties will have to accept the high transactions costs of early DIB pilots. Foundations should consider subsidising these costs by **providing funding to catalyse the development of a DIB market**.

- DIB parties should invest in learning about this new approach; pilots should be **evaluated rigorously** and a group of donors and philanthropic organisations should set up a DIB **Community of Practice** to share and accelerate learning.
- DIBs should be **open by design**. Openness will accelerate confidence in DIBs for investors, governments, service providers and taxpayers and help to build a high quality market. Donors and foundations should lead on establishing a **research data protocol** which would provide a standard of data and facilitate information-sharing.

This report sets out more detailed recommendations for the key groups who can make DIBs happen: donor agencies, trusts and foundations, investors, governments of developing countries, intermediary organisations, and service providers. We also lay out broader recommendations for all of these actors which the Working Group has identified as first steps in the development of a market for DIBs.

The report is divided into three sections: Section 1 explains the concept of DIBs, challenges for development funding that the approach addresses, its value over alternative funding mechanisms, and what is needed to create a viable DIB market. Section 2 explores six DIB case studies to illustrate the breadth of social issues to which the approach can be applied and considerations for the design of DIBs. Section 3 provides more detail on technical considerations for audiences interested in exploring the implementation of DIBs.

Development Impact Bond Working Group Recommendations

RECOMMENDATIONS BY ACTOR

A. DONOR AGENCIES

- ***Make room for new partnerships to develop DIBs:*** Development Impact Bonds are a new approach, and projects cannot be easily put together using the existing procurement systems of most public sector agencies. As the development of early DIBs is likely to be driven by commitments from outcome funders, we recommend that donor agencies consider how current systems can be adapted to allow them to take on the role of buying outputs and outcomes, which creates space for local actors to be innovative in their approaches to service delivery. Essentially, DIBs are about forming partnerships, and to adopt this new approach donor agencies should work closely with recipient country governments, potential investors, intermediaries and service providers. This collaboration will help ensure that DIB contracts developed are attractive to investors, create the right incentives for service providers and offer good value to outcomes funders, and so establish a good starting point for future deals.
- ***Establish a DIB Outcomes Fund:*** Given the novelty of the approach and higher transaction costs likely to be associated with initial DIBs, individual donor agencies may find it easier to jointly fund outcomes of DIB projects. We recommend that a consortium of donors sets up a **DIB Outcomes Fund** to pool risk for initial DIB projects and to more easily share lessons learned. The Fund could be set up as a challenge fund, from which DIB intermediaries and other potential project implementers compete for funds, leading to innovation in design and the channelling of funds to the best-designed DIB proposals. To set up such a fund, donors could take advantage of existing joint efforts such as the Global Development Innovation Ventures (GDIV) platform set up by US Agency for International Development and UK Department for International Development. GDIV could be used to test innovative interventions under DIB models and drive results by committing more flexible funding to pay for the outcomes of successful interventions.
- ***Convene and participate in a DIB Community of Practice:*** As DIB pilots emerge, to ensure that information is shared, disseminated, and ultimately applied, we recommend that an organisation of global reach and convening power, perhaps using the platform of the Global Partnership for Effective Development Cooperation, establish a **DIB Community of Practice**, consisting of donors, investors, DIB development intermediaries, government agencies from developing countries and larger service provider organisations, who would share their experiences and provide a forum for disseminating lessons that will inform the development and use of these instruments going forward. The Community of Practice should use lessons from Social Impact Bonds in developed countries and other forms of payment-by-results contracts.
- ***Insist on credible independent measurement and/or verification:*** Donor agencies should require that outcome metrics be independently measured and reported by a third party to ensure that all parties have confidence in the results achieved.
- ***Promote openness and transparency:*** To reduce transaction costs and help build an evidence base for DIBs, pilots should be developed, implemented and evaluated in

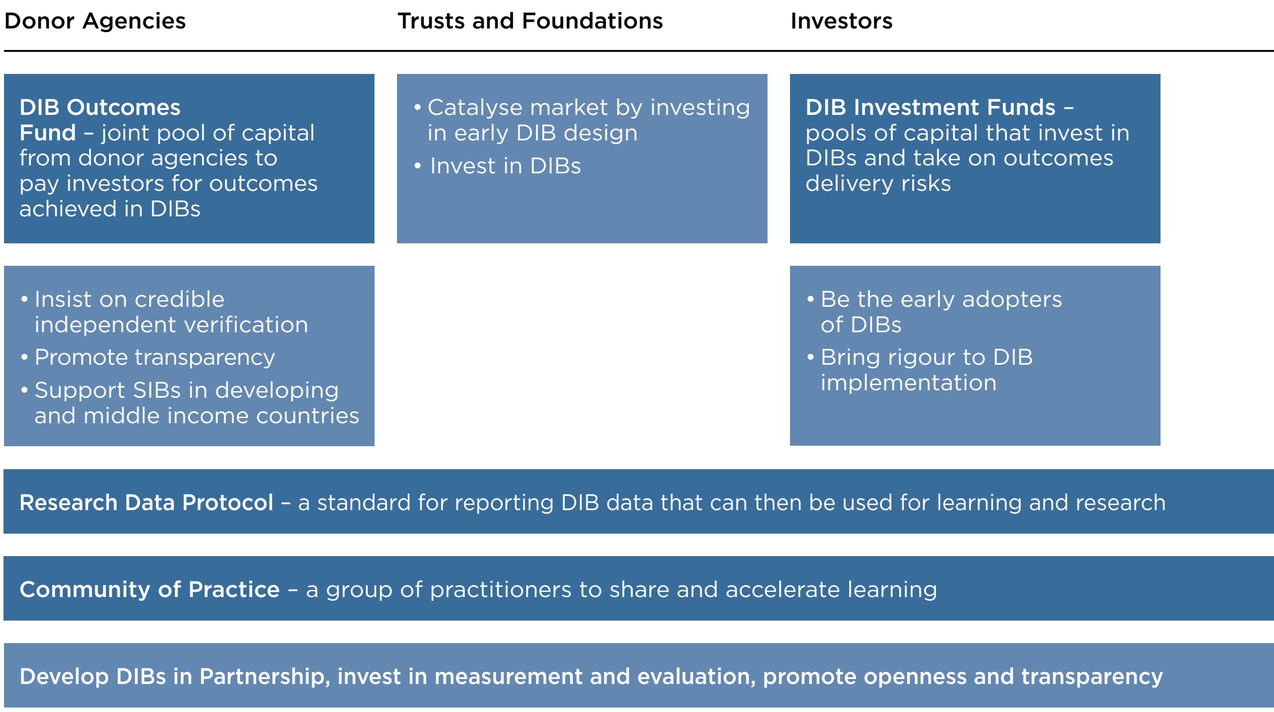
a transparent and "open source" way. Donor agencies can drive transparency in DIB transactions by requiring that outcomes data be made public, and contracts also be published. As a results-based approach, DIBs are meant to improve information about the impact of donor funding. This is only possible if information about how funding is being used and the results of programmes are publicly known (see Overall Recommendation #3 for more on how all DIB actors can help to ensure that the design and implementation of DIBs are open processes).

- ***Support Social Impact Bonds in developing countries:*** Donors should support the effective and efficient use not only of their own development funds (through DIBs) but also that of the partner countries in which they operate (through SIBs). Donors could do this either by setting aside grant funding for this purpose or by sharing knowledge through the DIB Community of Practice and other vehicles.

B. TRUSTS AND FOUNDATIONS

- ***Help lay the groundwork for early pilots:*** In the short term, designing, developing and implementing early DIBs will involve high transaction costs. Given the newness of the approach, donors and/or investors may be unwilling to be the first to invest resources into building the DIB market. Foundations can make a big difference by providing subsidies that would catalyse the development of this market. Funds could be used to generate awareness of the DIB approach and its potential value; support the technical work of intermediaries who are likely to be pulling the first transactions together; and fund research to pool learning from early DIBs to help build an evidence base. The challenges that donors will face in piloting the first DIBs will also apply – arguably to an even greater extent – to governments in developing countries trying to pilot SIBs. Thus, foundations should consider subsidising some of those same start-up costs in developing countries.

Figure 1: Recommendations by actor



- ***Invest in DIBs:*** In the longer term, trusts and foundations could consider investing more of their assets in impact investments more generally, and DIBs in particular, to gain both financial and social returns from their transactions.

C. INVESTORS

This set of recommendations is for socially motivated individuals and organisations who are likely to be the investors of early DIBs; this could include trusts and foundations, development finance institutions and high net worth individuals.

- ***Be the early adopters of DIBs:*** The first DIBs are likely to be regarded as high risk by commercial or institutional investors as they are an unknown structure without a track record and involve implementing programmes through non-government organisations in developing countries. Social impact investors, who may be willing to take on higher risks in order to generate greater social impact, can be the trailblazers who make the first investments into DIBs/SIBs, thereby helping to crowd-in other private investors and catalyse the emergence of a deeper and broader market for investment in development outcomes.
- ***Set up DIB Investment Funds:*** Given the innovative nature of DIBs, raising capital for the first DIB transactions on a deal-by-deal basis could be a labour-intensive and time-consuming process. Investors could contribute to funds that would provide ready pools of capital to invest in DIBs, possibly organised according to sectors of interest to a group of investors. These **DIB Investment Funds** could, for example, be managed by a financial intermediary and could pool funds from development finance institutions, trusts and foundations, high net worth individuals, and others wanting to invest for both financial and social returns. Funds could also be initiated by one large institutional

Partner Governments	Intermediaries	Service Providers
• Identify DIB suitability • Provide space for service providers to innovate • Consider funding SIBs	• Bring together DIB parties • Support DIB design and implementation • Share learning	• Contribute to DIB development • Adapt systems for results based contracting

investor such as a development finance institution. Bringing these investors together via DIB Investment Funds would help to reduce the amount of time and resources needed to raise capital for each DIB opportunity and would improve efficiency of the due diligence and transaction structuring processes.

- ***Bring rigour to DIB implementation:*** DIBs align incentives by tying investors' financial returns to the achievement of social outcomes. To ensure that this leads to more effective service delivery and improved results, investors – or investment funds or intermediary organisations on their behalf – must be actively engaged and willing to offer their expertise. For example, by bringing rigour to DIB service delivery, performance management and outcome measurement, investors can play an important role in driving performance to achieve better social outcomes.

D. GOVERNMENTS IN DEVELOPING COUNTRIES

- ***Identify DIB suitability:*** Governments, including regional and local authorities,[1] need to play a key role in selecting and screening DIBs, often in partnership with donor agencies, for instance by identifying complex social issues that could benefit from results-based approaches, a greater shift of resources towards preventative efforts, and/or private sector expertise.
- ***Give space for service providers to innovate:*** DIB contracts are structured around desired programme outcomes and are designed to allow local service providers more flexibility to tailor solutions to circumstances on the ground than they would have under traditional input-oriented contracts. Partner governments should allow space for service providers – including local government service providers where applicable – to innovate and modify interventions such that they are better able to adapt to the needs of the local population and achieve better development outcomes.
- ***Stay involved throughout the DIB lifecycle:*** The involvement of developing country governments in the design and implementation of DIBs – in a variety of roles including as outcomes funders, co-managers of contracts, service providers and/or observers/consultants – will ensure that DIBs reflect national priorities, take into account the local context, and spread learning to other public services.
- ***Consider funding SIBs:*** Where domestic resources for funding outcomes are available, emerging economy governments, including local authorities, could develop SIBs with funding and assistance from donors if necessary.

E. INTERMEDIARY ORGANISATIONS

- ***Help bring together DIB parties to make transactions happen:*** Intermediaries can help represent parties not in the room and support the negotiation of an agreement that fits the needs of all those engaged in the process. The experience of developing the Social Impact Bond market shows that intermediaries can play a critical role in getting transactions off the ground.
- ***Support DIB design and implementation:*** Particularly in early DIBs, intermediaries can play an important part in supporting DIB design and implementation, beyond the role of coordination. In particular, intermediaries can provide support to DIB parties

1 Taken throughout to include other public entities such as public utilities

according to demand in: feasibility assessment, contract development, capital raising, due diligence, performance management, service commissioning and capacity building.

- ***Contribute to the Research Data Protocol:*** Intermediaries should embrace openness in DIBs, including providing input into the design and setup of the Research Data Protocol and sharing data from DIB projects according to agreed Protocol data standards.
- ***Share learning and help further understanding of DIBs:*** Intermediaries should participate in the proposed Community of Practice and help further understanding of DIBs via conferences, publications, secondments and partnership working. This can help to facilitate a common understanding of DIBs and how they can be most effectively applied.

F. SERVICE PROVIDERS

- ***Contribute to development of DIB intervention models:*** Service providers hold existing relationships to service users and their communities and may be well placed to assess what intervention is needed. Where relevant, providers should collaborate with donor agencies, national and local authorities in developing countries, target beneficiaries and other DIB parties to develop the DIB intervention model to ensure its relevance to the target population.
- ***Adapt systems for results-based contracting:*** Service providers may be unfamiliar with the requirements for delivering results in an outcomes-based contract. Being open to adaptations in terms of resources, processes and systems necessary for results-based contracting can help increase providers' ability to adjust their services in response to the emerging needs of the population and increase their impact.

OVERALL RECOMMENDATIONS

The Development Impact Bond Working Group makes the following recommendations for all actors exploring Development Impact Bonds, to encourage the development of early DIBs and the establishment of a viable market:

1. ESTABLISH OUTCOMES AND INVESTMENT FUNDS TO PILOT A RANGE OF DIB MODELS

Interested investors, governments and donors, service providers, and intermediaries should explore how DIBs could improve the impact of development funding. A range of models – in terms of target outcomes, locations and structures – should be piloted to enable testing of different models of intervention and learning about the benefits and challenges of the DIB approach.

To facilitate the implementation of early DIB pilots, we recommend that a consortium of donor agencies establish a **DIB Outcomes Fund** (see p. 36). A commitment from multiple donors to pay for outcomes achieved in DIB contracts would catalyse the development of sound DIB propositions for investors and help get the first transactions off the ground.

Similarly, we recommend that investors set up **DIB Investment Funds**, which provide ready pools of capital for investment into DIBs. By reducing the amount of time and resources needed to raise capital for each DIB opportunity, DIB Investment Funds could enable the launch and implementation of early DIBs within a shorter timeframe and help catalyse market growth.

2. INVEST IN LEARNING ABOUT A NEW APPROACH

Early DIBs should be rigorously and independently evaluated. Evaluations should include information on intervention costs and pricing of outcomes and results, and assess whether and how the structure helped to lead to improved outcomes, in addition to including details of any positive or negative externalities. DIB actors should use learning from evaluations to improve the future design of results-based contracts.

To ensure that learning is shared, we recommend that a group of donors and philanthropic foundations establish a DIB Community of Practice of potential donors, investors, DIB development intermediaries and government agencies from developing countries to share learning from early DIB pilots and advise on the development and application of the model going forward.

This group should also consider lessons from Social Impact Bonds in developed countries and from other forms of payment-by-results contracts. DIBs involve many of the same challenges, including: defining appropriate outcome metrics; the need for multi-year donor funding commitments; and addressing public sector agencies' need to be accountable for programmes when they are not defining the way in which outcomes should be achieved.

3. MAKE DIBS OPEN BY DESIGN

We recommend that Development Impact Bonds are open by design. DIBs are a mechanism that encourages innovation and learning in service delivery and those lessons are most valuable if they are widely shared. Openness will accelerate confidence in DIBs for investors, governments, service providers and taxpayers and help to build a high quality market.

To enable the sharing of data, we recommend that foundations and donors who commit to funding DIBs consider establishing a **research data protocol**, which could build on existing reporting standards and be used to collect project-related data, including data on intervention costs, value of outcomes and impact data, which should be made available upon request from the public. The protocol could be enforced on all projects that receive outcomes payments from the DIB Outcomes Fund (as per Recommendation 1) and could become standard contractual practice thereafter.

DIB actors should accept the principles that data should be made available for free, in a timely manner, and in accordance with agreed standards that will make data comparable and over time reduce the cost of DIB development. More specifically, to ensure openness in the design and implementation of DIBs:

- Outcomes data should be made public when outcomes are measured to trigger payments.
- DIB contracts should be publicly available so that taxpayers understand how DIB funding is used and so that over time the cost of the contracting process could be reduced. Contracts should be fully transparent about the investments.
- More detailed information, such as intervention costs, additional input costs, breakdown of outcomes by different populations or areas etc. should be made available over time.

4. ACCEPT ONE-OFF COSTS OF BUILDING A NEW MARKET AND INTRODUCING A NEW TOOL

The first DIB pilots will involve high transactions costs as all actors involved adapt to a new model of outcomes-based contracting that is backed by private investment. DIB actors, particularly outcomes funders, will need to invest resources in understanding and assessing the feasibility of implementing DIB structures, valuing outcomes and pricing risks (described in detail in Section 3). To ensure that initial pilots are not prohibitively expensive, funding should be made available for the design costs of early DIBs. This type of catalytic funding could ensure that outcomes funders and investors do not absorb the costs of "building a market" into the costs of early DIB pilots.

We recommend that foundations consider investing in the development of a DIB market, for example by providing funding to intermediaries to do this design work, as a catalytic public good. Experience from the development of Social Impact Bonds has shown that intermediaries have a key role to play in pulling together early pilots. Having a specialised organisation acting as the champion of the project, undertaking crucial feasibility work, coordinating DIB actors, representing parties not in the room and negotiating an agreement that fits the needs of all those engaged in the process, is likely to be just as important in the context of DIBs.

5. SUPPORT THE BROADER ADOPTION OF SOCIAL IMPACT BONDS (SIBS) IN DEVELOPING COUNTRIES

As economies grow and tax collection improves, governments in developing countries have a growing pool of domestic revenues to finance government spending. We recommend that governments in developing countries consider using these revenues to pay for outcomes under Social Impact Bonds, and that donor agencies or foundations encourage the effective and efficient use not only of their own development funding (through DIBs) but also that of the partner countries they support (through SIBs, as they have been designed in industrialised countries). Because we expect developing country governments to face the same – if not higher – start-up costs in getting early SIBs off the ground, we recommend that donors and foundations consider funding some of the start-up costs associated with developing SIB markets, share learning, and provide technical assistance as needed. Although transaction costs may appear high at the beginning, it is likely that, over time, the cost of developing SIBs and DIBs will decrease due to sharing of information and learning among DIB actors as more products come to market.

DIBs are a financial instrument that can bridge the gap between investors and opportunities, and between financial returns and social benefits.