A primer on impact bonds

A beginner's guide

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Governments across the world face the devastating economic repercussions of COVID-19. The public sector struggles with tight budgetary constraints as the demand for efficient welfare services and economic revival increases. Impact bonds can emerge as a solution that eases the burden of governments worldwide. They are a results-based financing mechanism that draws private capital into the development sector. Worldwide, the private sector has invested USD 437.27 million up-front capital through 216 impact bonds. Each bond, valued at USD 3.12 million, has served 12,457 beneficiaries.

Over the past two decades, governments and multilateral organizations have used results-based financing to direct funds effectively to populations in need. The World Bank defines result-based financing as "an umbrella term referring to any program or intervention that provides rewards to individuals or institutions after agreed-upon results are achieved and verified." Impact bonds are a form of result-based financing.

What are impact bonds?

An impact bond is a multi-stakeholder contractual partnership between public and private organizations or among private organizations. These bonds seek to fund social services programs to fund services against a socially driven mission to achieve intended developmental goals or outcomes within a stipulated period. An impact bond usually involves an outcome funder, a risk investor, a service provider, and an intermediary. The roles of each of these stakeholders are described below:

Outcome payer:

The outcome payer selects the developmental cause, sets outcomes to be achieved in a development intervention, and defines the timeline. They provide funding to achieve the intended impact and outcomes. A social impact bond can have a government as an outcome payer, while a philanthropic organization or donor generally funds development impact bonds.

Risk investor:

A private investor provides upfront or working capital for the impact bond. The outcome payer provides the principal and interest to the investor only after the project achieves the desired results and the evaluator verifies them. Stakeholders decide the rate of interest based on the results. If the bond fails to complete the predefined goals, the investor loses money.

The service provider:

Typically, service providers are non-governmental organizations (NGOs), private service providers, or consortiums. They use capital provided by the risk investor to work on-ground and deliver the outcomes defined in the contract.

The intermediary:

This stakeholder brings together all players in an impact bond. It builds an optimal contract as per the requirements and capabilities of the outcome payer, the risk investor, and the service provider. The intermediary often handles the flow of funds from the risk investor to the service provider and from the outcome payer to the risk investor.

The evaluator:

The evaluator is an independent or third-party organization that monitors and evaluates the progress of the bond against the predefined outcomes.

How did impact bonds come about?

The United Kingdom issued the first impact bond of the world, the Peterborough Social Impact Bond, in 2010. It sought to reduce the chance for criminal offenders with short sentences to relapse into crime. Such people often left prison with limited support services or employment and consequently reoffended. Social Finance helped raise[1] GBP 5 million to address this problem through a consortium of government partners. The objective was to address the needs of offenders through various support services to help stop the cycle of reoffending.

The Ministry of Justice of the UK government declared the bond a success in 2017, seven years after its launch. The bond reduced reoffending rates by 9%, compared to a national control group. This number was higher than the targeted 7.5%. Consequently, all 17 investors received their principal with 3% annual interest for the investment period. This impact bond marked a watershed moment for innovative financing tools worldwide. More than 200 impact bonds have been launched since 2010, with around 19 bonds issued for projects in developing countries.

The infographic below illustrates the first social impact bond issued by the Department of Justice of the UK government in Peterborough.

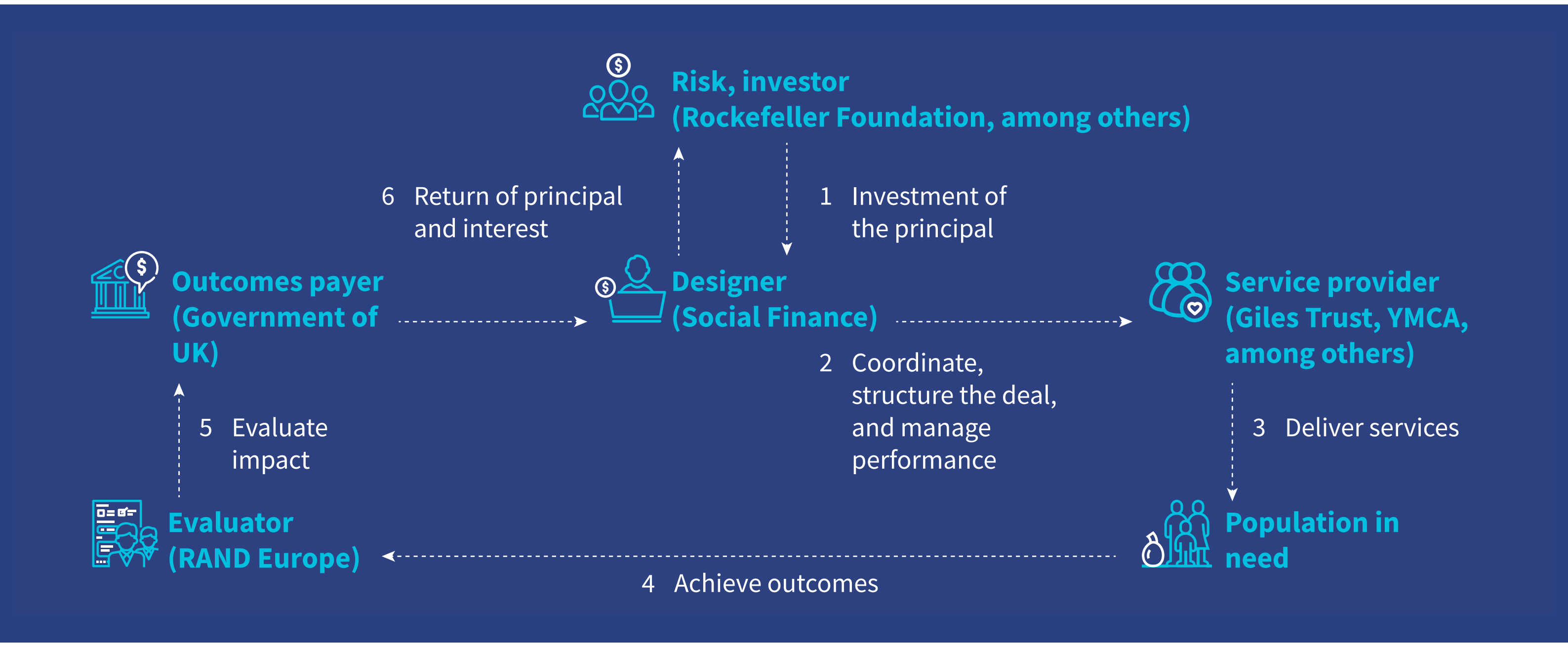


Figure 1: Illustration of the first impact bond in Peterborough, UK

Social Finance, the intermediary and designer of the Peterborough Social Impact Bond, brought together the project's stakeholders. These included the Department of Justice as the outcome payer, and the Rockefeller Foundation, Barrow Cadbury Trust, and The CowPat Trust, among many others, as risk investors.

How do impact bonds work?

An essential component of an impact bond is deciding the outcome metrics and the related pricing and reward structure. For example, if a bond seeks to achieve better education outcomes, stakeholders must first agree on the specific measurements and targets, including attendance and retention rates and learning outcomes as judged by standardized testing. The risk investor and outcome payer should also agree on the rates of return determined by the achievement of outcomes.

If the outcome payer among other stakeholders considers a project's outcomes successful, they can refinance the bond to serve a larger population rather than returning the principal and interest. The government or outcome payer can also step in and directly fund the expansion of services as the model has been tested.

Each stakeholder benefits from the structure of impact bonds. The service provider receives funds for the interventions and the freedom to tweak their interventions as the risk investor focuses on the outcomes. The risk investor receives the principal invested with interest, ranging from 1% to 20%.[1] They can also capitalize on the goodwill generated from investing in projects that further social progress. The outcome payer bears no risk in this model, which eases their fiscal constraints and provides a source of alternative funding for the social sector. This model enables governments to deploy scarce resources for innovative and successful development interventions optimally.

This structure emphasizes serving the population in need. The structure of impact bonds ensures that risk investors encourage service providers to offer optimal service, which benefits the population in need. While this is the most commonly used structure for impact bonds, structures are subject to the participation levels of stakeholders, and their requirements vary accordingly.

Are impact bonds the future of social development financing?

Impact bonds have gained traction over the past decade due to their many advantages. We discuss some below.

1. Encourages tailored solutions

Challenges in the social sector are usually complex and need customized and targeted solutions. Moreover, governments of developing countries lack effective procurement processes to deploy innovative solutions. The structure of an impact bond allows the service providers to innovate and customize. At the same time, the government or outcome payer is concerned primarily with the outcomes.

2. Focuses on results

All stakeholders involved in the impact bond understand that the return of their investment depends on the outcomes and not the effort alone. A minimal effort that fails to achieve desired outcomes is not rewarded. Consequently, the drive to achieve targeted outcomes ensures the authenticity of data collected and rigorous evaluation of the impact. This helps establish real progress on the ground.

[1] Findings from 50 completed impact bonds out of all 216 impact bonds issued so far

3. Attracts private investment

The most significant benefit of impact bonds is their ability to attract socially driven private investors into sectors where outcome-based financing has proven successful. Many private organizations are attracted to the "double bottom line"—the return of their investment with interest and the added benefit of contributing to a social cause. Such investors help plug financing gaps and address development issues.

4. Even when the project fails, the model works

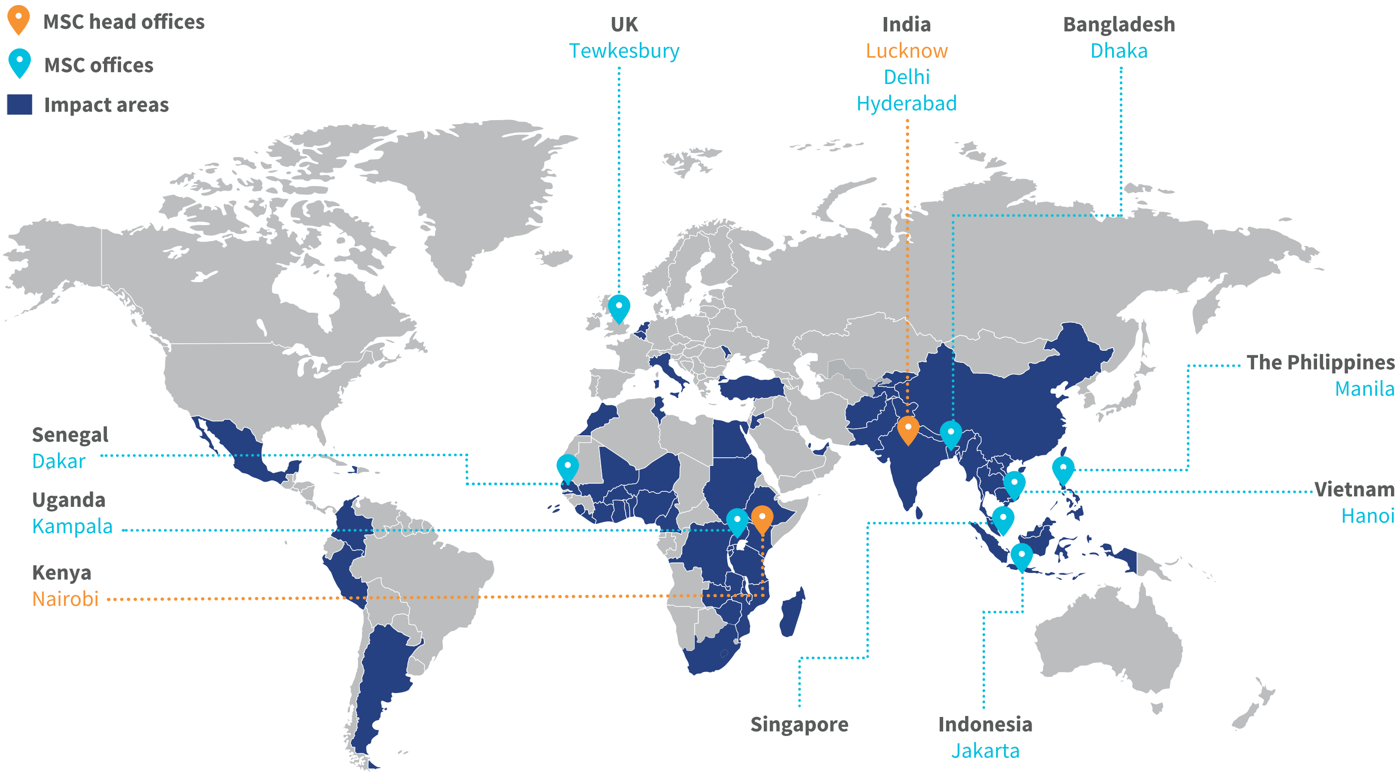
The US had to discontinue its first social impact bond early due to unsatisfactory results. However, even in this case, the mechanism worked as intended. When the project evaluator revealed that services did not achieve the set metrics or goals, the risk investors bore the loss, and the government saved public finances.

Stakeholders must refinance, expand, and duplicate impact bonds for them to flourish in a dynamic ecosystem. Several factors reinforce the value of impact bonds in today's world. These include the increasing commitment of the public sector to innovation, data, and evidence-based policies, the ability of the social sector to develop promising interventions for social issues quickly, and ample risk appetites of risk investors.

MSC will design impact bonds and advise governments, private investors, institutional investors, and multilateral institutions. We seek to converge the investment goals of these stakeholders to achieve meaningful social outcomes. Our sectorial and advisory expertise, obtained through projects with multiple governments, institutions, and philanthropic organizations, is ideal for achieving the desired social impact.

MSC's Catalytic Finance practice will turbo-charge the impact investing space with its ability to facilitate, structure, and execute multi-stakeholder partnerships. The practice will accelerate purposeful private sector investments to achieve lasting impact solutions.

Do you want to work with us or seek more information on our ideas and practice? Feel free to reach out, and we will be happy to explore the possibilities with you. Follow this space to find out which sectors we believe are best suited for impact bonds.



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