Deutsches Institut für Entwicklungspolitik
German Development Institute
d·i·e

Briefing Paper 20/2015

Financing Global Development: Is Impact Investing an Investment Model with Potential or Just Blowing Smoke?

Summary

The Briefing Paper series "Financing Global Development" analyses key financial and non-financial means of implementation for the new Sustainable Development Goals (SDGs) and discusses the building blocks of a new framework for development finance.

Financing social service delivery is becoming more and more challenging. At the same time, private assets are increasingly seeking out investment opportunities. Some high-net-worth individuals and foundations are accepting lower returns as long as pressing societal objectives can be achieved. This presents an opportunity to mobilise more private capital for social investments. The so-called impact investors can play a promising role in financing social and environmental service delivery in G7 countries as well as in the developing world. Impact investing is intended to finance projects, organisations and social enterprises to intentionally create a measurable social or environmental impact alongside financial returns. One innovative instrument is the so-called social impact bond (SIB) – or, in the case of development cooperation, development impact bond (DIB) – through which private investors pre-finance the intervention, and governments or donors provide funding solely when the intended outcome goes beyond what would have occurred otherwise.

Advocates of impact investing see SIBs and DIBs as useful instruments for the financing of the 2030 agenda. However, they are still largely unproven; even though some promising interim evaluations exist, this innovative financing approach faces a number of challenges. Besides questionable or outstanding evaluations, the most important challenges are: limited transferability, the nascent development of the market, high transaction costs and the hurdles for investors. Nevertheless, given the urgency to mobilise finance for sustainable development in developed and developing countries, it is worth considering and prudently developing impact bonds further, and more generally impact investing. Supporting them would entail:

- Data- and information-sharing have to be furthered by the impact investing community in order to critically evaluate first experiences of pilot SIBs and DIBs, provide recommendations and enable basic education for entrepreneurs and investors.
- Further research should be encouraged to get a better understanding of how to create additional impact and to deploy different instruments in the development context as well as to offer exit opportunities for private investors.
- Policy-makers should support the development of clearer definitions and a common impact-measurement system as well as standardised and mandatory reporting requirements to ensure effectiveness and quality.
- Development finance institutions should become more active in the market by providing resources to encourage the implementation of SIBs and DIBs. Governments and/or donors need experienced partners who provide catalytic capital for first initiatives and serve as intermediaries.

Impact investing to finance social services in the G7

There is a growing awareness among governments that existing public resources are insufficient to finance social services and address poverty, inequality and other multidimensional social challenges. In its recent "World Social Protection Report 2014-15", the International Labour Organization warns about the consequences of further social spending cutbacks, especially in Europe. In such times, investment models such as social impact investing become increasingly attractive (Organisation for Economic Co-operation and Development, 2015). But does impact investing indeed have the potential to finance today's challenges?

Advocates of social finance and investing – impact investing – believe that it will be possible to unleash up to US$ 1 trillion of new investments in the social impact investment market (Social Impact Investment Taskforce, 2014). Other, even more enthusiastic sources claim that the market could grow to US$ 3 trillion. The assessment of whether these estimations are far too optimistic or not depends partly on the underlying definition of impact investing.

The question of investing with or for impact

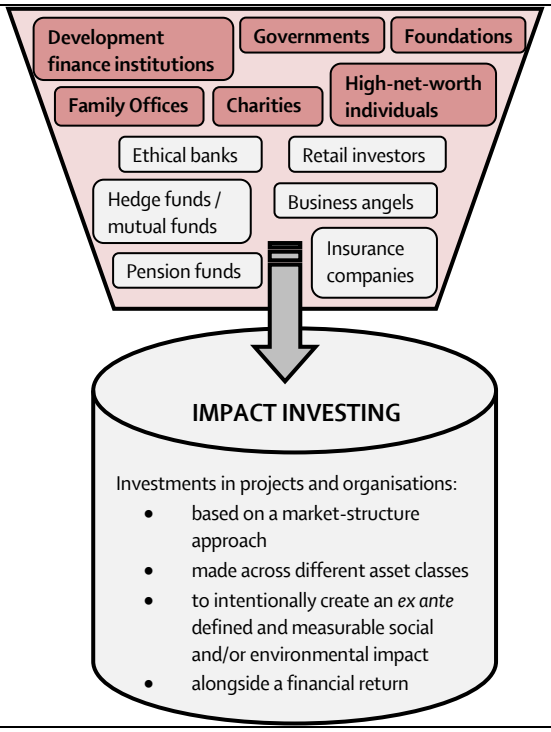
So far, an exact definition of impact investment does not exist. Consequently, many market actors are calling themselves "impact investors" for marketing purposes. However, the G7 task force on impact investment defines impact investing as investments that are made into non-profit as well as for-profit companies, organisations and funds in order to intentionally generate a measurable social or environmental impact alongside a financial return ("investments for impact") (see Figure 1). The financial return of the project should be positively correlated with the social, respectively environmental, outcome, which must be based on a verifiable result. Thus, investments that produce impacts that are not quantifiable and measurable or that are only relatively better than alternative investment options ("investments with impact") are not considered impact investments in this definition.

Impact investments can be realised through direct investments (debt or equity); however, a more general and less costly way to invest for impact can be through investments made into impact funds. Successful examples include social investment funds as well as social venture funds. They allocate capital to social enterprises – micro, small and medium-sized businesses – with socially and environmentally responsible business approaches.

Impact investors include development finance institutions (DFIs), governments, institutional investors such as pension funds and insurance companies, as well as corporations, foundations, family offices and high-net-worth individuals. In particular, philanthropists are seen as a new investor group that has great potential for the rising impact investing market. The reason for this is that, other than institutional investors, they are less bound to fiduciary duties and do not face so many regulatory constraints.

Compared to conventional investors, these philanthropic investors (i.e. high-net-worth individuals, family offices and foundations) are – at least theoretically – able to absorb more risk. In addition, one could assume that they should be more willing to take over first-loss shares, a role that traditionally is solely assumed by sovereigns. Thus, they could help to de-risk the impact investing ecosystem and encourage innovations by unlocking substantial capital through the provision of guarantees and catalytic capital.

Figure 1: Definition



Source: Authors

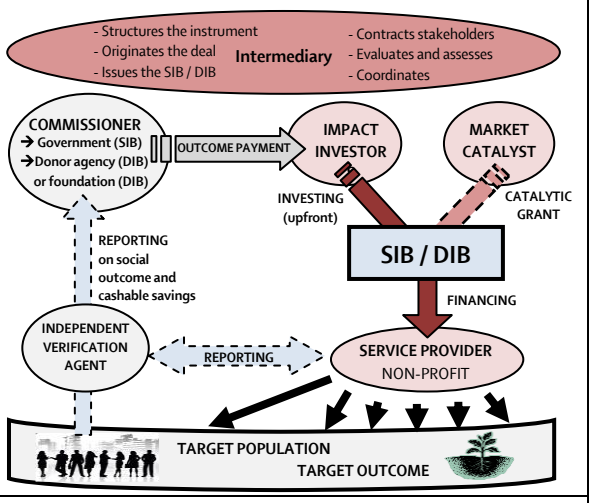
Social impact bonds: A qualitative approach

Among the different instruments used for impact investment, SIBs in particular – a term that originated in the United Kingdom for a result-based or pay-for-outcome contract for preventive measures – emerged as promising instruments. The innovative feature of these public-private partnerships is their qualitative approach: by shifting the responsibility for social and environmental intervention from the government to a service provider and the risk of failure to private investors, the government pays only for the outcome if the intervention has been successful.

Figure 2 illustrates the structure of an impact bond (IB): in the case of an SIB, the government contracts on a pay-for-success basis with a private-sector intermediary, the SIB delivery agency. The relevant group of investors provides the upfront funding for the preventive project. Philanthropic investors can also play an important role as catalysts. Under the most common SIB model, the intermediary originates the deal and assesses the potential structure and application of the programme. After raising funds from private investors, a service provider contracts

with the operator and is provided with the required capital and technical assistance in return. The service provider works closely with the targeted population in order to deliver the required social or ecological outcome. The ultimate goal of the service provider is to achieve an overall effect that saves public expenses in excess of the overall costs. The desired effects are being assessed, documented and reported by an independent evaluator that guarantees the integrity of the results and builds stakeholder confidence. In case there is a measurable positive impact that reduces the need for expensive *ex post* remediation, the commissioner repays the invested principal with an additional premium that, in turn, depends on the actual outcome. The only difference between an SIB and a DIB lies in the identity of the commissioner: the national government in the case of an SIB, and a donor in the case of a DIB.

Figure 2: Impact bond structure



Source: Authors

Impact bonds to finance development

Evidently, this approach – that is, focussing on the outcome of the programme – is also an attractive way of financing social and environmental service delivery for developing countries (Center for Global Development and Social Finance, 2013). Indeed, result-based contracts have already been discussed for some time in development cooperation, as they enable governments as well as DFIs and donor agencies to define the most effective measures for tackling challenging socio-economic issues. As governments of developing countries have access to increasing domestic resources, the implementation of SIBs has the potential to unlock upfront capital for developmental programmes, promote autonomy and cooperation, and help governments of emerging economies to escape from financial dependencies.

However, IBs in developing countries are just starting. Instiglio – the first specialised intermediary dedicated to promoting the advancement of IBs in developing countries – documents two IBs in the implementation stage, namely in India (education) and in Peru (cocoa and coffee). A few more developing countries (Chile, Colombia, Costa Rica, Uganda and South Africa) are designing IBs for diverse efforts such as reducing recidivism and youth unemployment, water conservation, sleeping sickness and early childhood development. Further relevant areas for IBs in developing countries include criminal justice (youth gangs), governance (tax collection), health care (safe drinking water, disease prevention and family planning), education (financial literacy, school attendance) and the environment (tropical forest preservation, climate change).

A building block for financing the SDGs?

Advocates of impact investing see a great potential for IBs to contribute towards the realisation of the new SDGs – given the universality of the 2030 agenda, both in developing and developed countries. In fact, IBs can help to improve transparency and encourage the implementation of data collection and measurement systems for development outcomes. They offer the potential for enhanced coordination among different aid providers and the public and private sectors as well as for domestic resource mobilisation in developing countries. They offer upfront funding to service providers, and thus enable them to participate more actively in determining the most effective solutions. Indeed, the provision of pre-financing is a huge advantage over other result-based approaches. Last but not least, through the strong focus on impact, they can appeal to other investors and mobilise money from additional sources. Thus, they might be a useful complementary instrument for sustainable development financing.

Caution: All is not gold that glitters

There are also a number of reservations. First of all, IBs are just one of several innovative finance instruments that could be considered. They are relatively new and seem to have convincing features; however, they are still largely unproven. Normally, it can take up to 5–10 years until the success of an IB can be measured. Actually, for the pioneering Peterborough SIB – launched by the UK Ministry of Justice in 2010 – which aims at reducing the rate of recidivism of prisoners, the final evaluation is still being awaited. Although the first interim evaluations have been quite promising, the evaluation method – and consequently also the positive outcome – is facing strong criticism. Professor Sheila Bird of Cambridge University even goes as far as to say that, due to methodological weaknesses, the evaluation of the Peterborough SIBs was meaningless.

Moreover, even if one gives credit to the positive assessment of one of the pioneering SIBs, the positive evaluations are only partly transferable to other IBs: the design of every IB is far too specific for generalisations. Especially when thinking about IBs for other sectors such as, for instance, climate mitigation, the existing evidence is quite poor.

A further challenge is the development of the market for impact investing and the identification of experienced

partners among the social entrepreneurs who are capable of fulfilling the requirements needed for the intervention; especially as the underlying assumption of the concept of IBs is that these partners shall do a better job than the government would have done. Indeed, it is even questionable whether shifting the responsibility for the solutions to social and environmental challenges from the government to private-sector agents is always desirable.

Furthermore, the design and implementation of an IB entail high transaction costs. Also, qualified monitoring and reporting are rather expensive.

Finally, up to today, the huge potential that is vigorously pointed out by the advocates of social impact investment relies mainly on theoretical number crunching. The majority of philanthropists and foundations have yet to be convinced that their role might be to build a bridge between charitable donations and return-maximising investments. For the time being, they are mostly as risk-averse as traditional (institutional) investors. Institutional investors though are kept from impact investing through tax and regulatory barriers, for instance the stricter regulation imposed by the EU for insurances: Solvency II. In fact, the actual potential of impact investing very much depends on the investment ecosystem in the respective countries. For instance, the United States and the United Kingdom have quite developed impact investing markets, whereas in Germany, with its sophisticated welfare system and relatively shallow capital markets, impact investing is still underdeveloped.

Some recommendations

Given the urgency to mobilise funding both for the 2030 agenda and for climate change mitigation and adaptation in developing as well as developed countries, it is worth considering the approach of impact investing, and in particular IBs. However, this should be done with the necessary common sense. Existing experiences have to be analysed critically to provide lessons-learnt, and both successes and failures have to be shared with the public all around the globe. Open knowledge-exchange will be essential to further develop the impact investing ecosystems. In addition, entrepreneurs as well as philanthropists and foundations need some basic education about what impact investing really means for them and how they could engage.

Moreover, more research and experiences are needed to explore the potential of IBs as alternative investment instruments for development finance. Therefore, it is important to encourage further research on the creation of additional impact, the application and implementation of different instruments in the development context as well as exit opportunities for private investors.

To ensure the necessary quality, policy-makers should support the development of a common set of impact-measurement methods as well as standardised and mandatory reporting requirements to ensure accountability and transparency. More generally, clearer definitions of impact investment and reliable verification agents are needed to make the concept of IBs marketable.

Indeed, launching an IB is a complex task, particularly in developing countries. Therefore, development finance institutions should assume an essential role in further developing the market in the future. Actually, they are already the largest source of impact investing; thus, they could specifically consider the implementation of IBs. They might serve as providers of catalytic capital to cover the high transaction costs – especially for the implementation of pilot IBs – and act as intermediaries by bringing the relevant actors together.

Literature

Center for Global Development and Social Finance. (2013). *Investing in social outcomes: Development impact bonds.* Report of the Development Impact Bond Working Group. Washington, DC: Author.

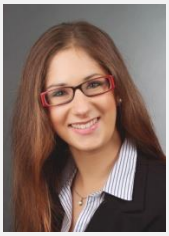
Organisation for Economic Co-operation and Development. (2015). *Social impact investment: Building the evidence base*. (Mimeo.)

Social Impact Investment Taskforce. (2014). *Impact investment: The invisible heart of markets – harnessing the power of entrepreneurship, innovation and capital for public good.* Report of the Social Impact Investment Taskforce established under the United Kingdom's presidency of the G8.

With financial support from the Federal Ministry for Economic Cooperation and Development (BMZ)

Dr Nannette Lindenberg
Senior Researcher

Department "World Economy and Development Financing"
German Development Institute /
Deutsches Institut für Entwicklungspolitik (DIE)



Caroline Pöll
Junior Expert

ING Commercial Banking

© German Development Institute / Deutsches Institut für Entwicklungspolitik (DIE)
Tulpenfeld 6 · 53113 Bonn · Germany · Tel.: +49 (0)228 94927-0 · Fax: +49 (0)228 94927-130
E-mail: die@die-gdi.de · URL: www.die-gdi.de
ISSN 1615-5483

The DIE is a multidisciplinary research, consultancy and training institute for Germany's bilateral and for multilateral development co-operation. On the basis of independent research, it acts as consultant to public institutions in Germany and abroad on current issues of co-operation between developed and developing countries.