Aidspan Independent observer of the Global Fund

The Global Fund explores the use of impact bonds and social success notes

In the beginning, there was performance-based funding. It was the outcomes-based mechanism of choice for the Global Fund and forms the foundation on which the Global Fund's grant architecture was built. The idea was simple. Release funding in tranches, whereby recipients were required to reach specific targets before the rest of the grant would be disbursed. That focus on results, which has been baked into the Global Fund process, is a primary driver of its success.

In recent years, a variety of innovative financing tools, including results-based financing, have surfaced to help channel resources to achieve greater social outcomes. Perhaps the most prominent example of this movement is the emergence of social and development impact bonds (SIBs and DIBs) that seek to mobilize private sector capital to fund proven social programs, with a promise to be paid back by the government if these programs successfully achieve desired social outcomes.

Impact bonds are one area that the Global Fund is exploring in its efforts to expand its work in innovative finance. It currently has projects in the very early stages of development in South Africa and Fiji and the organization hopes to be able to offer it as part of the toolkit it is creating to support its innovative finance program.

"The instrument, in terms of use in development, is still relatively new," said John Fairhurst, the Global Fund's Head of Private Sector. "Like others, we are very much building the sense of where these approaches can add the most value."

Impact bonds: How they work

In an impact bond, private investors provide upfront capital to service providers to deliver an intervention or program to a population in need. Upon the achievement of a set of agreed-upon results, the investors are then repaid by an outcome funder; in a SIB, the outcome funder is the government, while in a DIB, outcomes are financed by a third-party organization, such as a foundation or donor. In South Africa and Fiji, the Global Fund is supporting the design phase of setting up the impact bond. And although the Global Fund's role would change depending on the project and country context, Fairhurst said that it is unlikely the Global Fund would be an investor or guarantor in an impact bond project. Sponsoring design and being an outcome funder are two possible roles for the organization.

Projects funded by SIBs or DIBs are subject to frequent performance reviews by the outcome funders and the risk capital providers. Although course corrections can be made as activities are performed, there is a possibility that outcome funds may not be paid if targets are not achieved. This does not mean the activities are not performed as these are funded by the risk funders. When these instruments are well-designed, then outcomes would be paid through the life of the project as it progresses—not just at the end. One benefit of this approach for the Global Fund is that it will get earlier warning of off-track performance through the outcome funding.

In January, the Brookings Institution reported that six impact bonds have been contracted in low- and middle-income countries and that another 24 were either in early or late stage design. Across the impact bonds both contracted and in design, health is the most predominant sector, with 11.

Probably the most well-known impact bond is the Educate Girls DIB, where a multinational bank gave a girls education non-profit in India enough funds to scale their program to three new villages. Under the contract, a large education philanthropy will pay back the initial investment plus interest after three years based on the number of girls who have been enrolled in school and their learning gains. Second-year results from the DIB show enrollment at 88 percent of the target and learning progress at 50 percent of the target with another year of intervention to go.

Although these results are promising, impact bonds are not the easiest instruments to put in place. They demand a considerable time commitment and a steep learning curve from those engaged in the contracting process. And since they are relatively new and involve a wide variety of actors, some consider impact bonds to be too slow or unwieldy for the relatively small sizes of the investments to date. In fact, Fairhurst says that the design stage alone can take nine to 12 months. However, it is the most important part of the process as it is when core elements of the impact bond are clarified, including the definition of outcomes, their costing, and the legal structure that will be used.

Betting success on a note

Another instrument that the Global Fund is exploring is the use of the Social Success Note (SSN), an innovative pay-for-success financing mechanism that addresses the investment gap for small- and medium-sized social businesses. Created by the Rockefeller Foundation and Yunus Social Business, the first SSN pilot was launched in April.

SSNs are very similar to impact bonds, but are designed to help social businesses access scale capital while not being diverted from their social mission by the need to meet burdensome investor demands for returns. There are, however, a few differences between impact bonds and the SSN model, under which, for example, outcome payers are only responsible for paying a return based on performance; they do not have to cover the original investment, making it more attractive to potential outcome payers. The SSN also has a simpler structure than an impact bond to reduce transaction costs and time. In addition, complex impact metrics are avoided in favor of simple key performance indicators.

In the SSN pilot, the UBS Optimus Foundation is providing a $500,000 loan to Impact Water, a social enterprise, to expand its work installing low-cost UV-based water purification systems in schools across Uganda. Schools pay approximately $1,000 to Impact Water to install the system.

Impact Water will pay back the loan after five years and the rate of interest will go down if certain outcomes are achieved. If Impact Water achieves the agreed-upon targets, the Rockefeller Foundation will pay up to $200,000 to both pay off some of Impact Water's interest and pay UBS a performance-based return on its investment.

Although time-consuming and a bit cumbersome, Fairhurst believes innovative instruments like impact bonds and SSNs are an exciting area for the Global Fund and may provide the organization with flexibility to use its resources in a variety of ways. "We think it has real potential in some key areas, such as where it can de-risk innovation for the public sector, create new forms of contracting mechanisms, or where there is a misalignment of incentives in a diverse group of stakeholders—such as around regional and cross-border issues."

The Global Fund is reviewing a number of innovative finance approaches that could help it to achieve greater impact.

- The first article in this series in GFO 339 described the background and rationale for the change in policy and discusses the pros and cons of development cooperation mechanisms, such as debt swaps and blended finance.
- In the final article in this series, the Global Fund Observer will describe innovation and cost-reduction incentive mechanisms, and discuss the pros and cons of instruments, such as challenge funds and prizes, advance market commitments and seed funding.

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