INNOVATIVE FINANCING MECHANISMS FOR CHILD-FRIENDLY INFRASTRUCTURE

KNOWLEDGE BRIEF

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Global Infrastructure Basel Foundation (GIB) is a Swiss non-profit foundation working to promote sustainable and resilient infrastructure globally.

GIB engages with a wide range of stakeholders to build links between infrastructure projects and sources of finance.

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Introduction

Global Infrastructure Basel (GIB) Foundation in partnership with Stratigos, a firm specializing in the design and structuring of innovative financing structures, have explored what opportunities there are to mobilise additional financing for sustainable and child-frienly infrastructure projects using the SuRe® Standard. This knowledge brief gives an overview of the different financial instruments focusing on creating and measuring SDG impact and proposes a potential mechanism, which could be further developed to fit the need of attracting impact-driven capital into sustainable and child-friendly infrastructure projects.

A blended finance mechanism that combines traditional debt instruments with development financing and integrates social incentive payments, pay-for-success elements and crowd-sourced investment would be well suited to crowding in resources to SuRe®-compliant child-friendly infrastructure. The mechanism would cover the large investment needs of infrastructural projects but would also combine grant funding to enable integrating social and environmental sustainability as an integrated part of the scope of the projects. The grant funding and development financing would catalyse more private investments and could attract additional financing with a greater scale where it is needed to cover systemic social challenges. The impact could be verified through the child-friendly focused SuRe® Standard.

Context

As governments and the private sector, represented by actors ranging from philanthropists to asset managers, increasingly seek to use cost-effective approaches to align their capital with social outcomes, various models have risen that adapt conventional (and non-conventional) financial mechanisms to achieve financial returns and social objectives.

The global demand for provision of value-added services across a range of domains is increasing at a time when the resources available need to be ever more widely spread. In the face of this, innovative approaches to financing social initiatives are needed. Indeed, through the lens of the Sustainable Development Goals, The World Economic Forum estimates that there is at least a USD2.5 trillion annual financing gap to 2030[1].

However, the situation is not all bleak. A surge in popular interest in 'impact investments' following the publishing of "The Power of Impact Investing – putting markets to work for profit and global good" in 2007[2] is best captured by the interest of Millennials in making a positive impact along with making money – and with USD30 trillion due to be transferred to this generation over the next 30 years, the entire financial system is preparing to adapt to meet their demands[3].

At present it is estimated that the current size of the global impact investing market is $502 billion[4], meaning that there is huge scope for the Millennial Impact, as well as the acknowledged need for diversification of portfolios in every type of fund to avoid the traditional cycles of global financial markets, to grow into these double- and triple-bottom line investments.

Sustainable infrastructure projects focusing on children's needs are responding well to elements of the SDG agenda but due to decreasing public funds, private-sector investments are needed to bridge the funding gap in this sector too. However, commercial debt capital might not be available for new innovative infrastructure projects, such as child-friendly designs, especially in the developing country context where the margins can be low and the governance of the projects are far from being taken for granted. Impact-oriented financial mechanisms could serve the purpose better. This would allow focusing on children's wellbeing as the main impact metrics and not just on the financial return or the lowest price options.

As financial sustainability is already a part of the SuRe® Standard, the value of the social and/or environmental impact could be added to the cash flow assessment, which would highlight the overall sustainability and impact better and attract more impact-oriented investors. Having the right project governance in place is another dimension that is also analysed when applying the SuRe® Standard. Lastly, The SuRe® Standard is already fit to monitor the impacts of the projects and could easily adapt to track projected children's needs and welfare through their participation, safety, accessibility, mobility and rights.

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[1] *https://www.weforum.org/agenda/2016/07/blended-finance-sustainable-development-goals/*

[2] *Judith Rodin, Margot Brandenburg, Wharton Digital Press, 2014*

[3] http://www.wsj.com/video/preparing-millennials-for-a-30-trillion-wealth-transfer/BD7630BC-2A42-42ED-B921-51DFFE9F6F48.html

[4] *https://thegiin.org/research/publication/impinv-market-size*

Landscape of potential innovative financing solutions

A number of innovative financing mechanisms have been developed over the past decade to harness the growing impact investment interest and bring private capital into alignment with the Sustainable Development Goals. The most feasible instruments for child-friendly infrastructure projects are outlined below.

1. Impact Investing
2. Pay for success tools
3. Social yield notes
4. Blended finance mechanism
5. Islamic Finance
6. Social impact bonds
7. Disaster insurance
8. Crowdfunding

BLENDED FINANCE AND IMPACT INVESTMENTS

Blended finance is the strategic use of development finance for the mobilisation of additional finance towards sustainable development in developing countries. A small percentage of annual ODA funding allocated to blended finance has the potential to leverage significant amounts of private capital. But blended finance needs to be strategically targeted where cash flows can repay commercial investors.

Figure 1 – Blended Finance Supporting the SDGs (Source: OECD)

As shown in Figure 2, blended finance should not be used to address all SDGs - many SDGs are best funded by grants or sovereign loans. But 84% of all blended finance deals are aligned with Goal 9:

Industry, Innovation and Infrastructure.

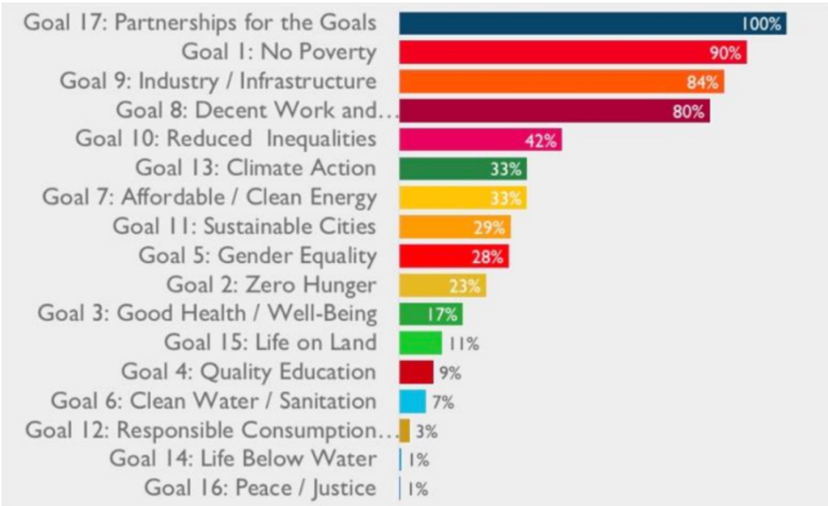

Figure 2 – Percentage of Blended Finance deals aligned with SDGs (Source: Convergence)

Impact investment assets under management have doubled each year over the past three years, from \$118bn in 2017 to \$228bn in 2018 to \$502bn in 2019. The main constraint for even further growth is a relative paucity in investible opportunities. Annual global demand for infrastructure development is \$3.7 trillion. Currently only \$2.7 trillion is invested each year. Globally, through 2030 over \$90 trillion[5] will need to be invested in infrastructure, more than the entire value of all current global infrastructure. A solid proposition around impact with a child-friendly lens using the SuRe® standard would align very well with the need for a much deeper impact investment pipeline.

RESULTS-BASED FINANING, PAY-FOR-SUCCESS, SOCIAL IMPACT BONDS, DEVELOPMENT IMPACT BONDS

Results-based financing initiatives, such as social and development impact bonds, seek to achieve social outcomes (i.e. impact) using mechanisms that minimise the use of inputs-based contracts, increase efficiencies, facilitate access to risk capital, decrease risk, and deliver a financial return to investors.

The core feature of an impact bond is the designation of a payment metric on which a target value is agreed. If the target is reached, the programme is deemed successful and the outcome funder releases the agreed payment – the upfront capital plus the success premium – to investors. This core design feature means that it is critical that the payment indicator specified be transparent and objective to all

[5] *The Sustainable Infrastructure Report. The New Climate Economy, (2016) 8.*

participants.

Instead of funding a specific intervention, the impact bond structure enables outcome funders to only pay when desired outcomes are achieved whilst giving providers the opportunity to innovate as to how they will achieve the chosen outcomes. The investors take on the financial risk of the provider failing to deliver on outcomes.

This structure gives flexibility for the investors, intermediaries and service providers to be responsive and adaptable to changing circumstances in order to achieve the most cost-effective, value-adding solution, which is a key difference to many other forms of PBR mechanisms. It also means that a heavy emphasis on the validation of the outcome metrics by independent agencies are necessary in order to provide the outcome funder the confidence that the outcomes that they are paying for have really been achieved.

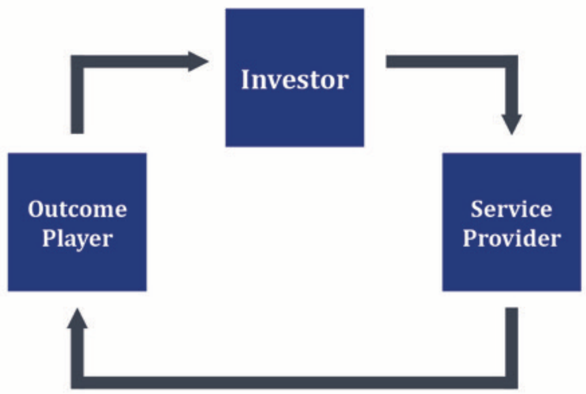

Figure 3 – The Finance Results Payment Cycle (Source: Instiglio)

The stages typically comprising the lifecycle of an impact bond are: i) feasibility study, ii) structuring of the deal, iii) implementation and iv) evaluation and repayment. During those phases, there are a high number of stakeholders involved and the resulting contractual arrangements governing the bond can become quite cumbersome. The Figure 4 depicts this complexity by showcasing the list of activities to be managed, executed, and monitor throughout the lifecycle of the impact bond.

Figure 4 – Categorisation of Impact Bond activities
(Source: University of Oxford & Blavatnik School of Government)

There are currently 151 impact bonds across 29 countries. Nine of them are in the developing countries and most of them focusing on employment, social welfare, education and employment. The average contract duration is 50 months and the total capital invested into impact bonds is currently $420.03million - consisting of the rather small portion of the whole impact investment market of $500billion[6].

Case Study 1
The Utkrisht Impact Bond is the world's first maternal and newborn health impact bond. The bond aims to reduce the number of mother and baby deaths by improving the quality of maternal care in Rajasthan's private health facilities. It will support up to 440 health facilities to improve services, meet new government quality standards and adhere to them over the long term. This partnership will reach up to 600,000 pregnant women with improved care during delivery over a five-year period and save up to 10,000 lives by improving the quality of private healthcare facilities that support a region of 75 million people.

The ICRC's world's first "Humanitarian Impact Bond" with the capital raised of 26 million CHF ($27m), will build and run three new physical rehabilitation centres in conflict-affected countries of Nigeria, Mali and Democratic Republic of Congo over a five-year period, providing services for

6 https://www.brookings.edu/wp-content/uploads/2019/01/Impact-Bonds-Snapshot-May-2019.pdf thousands of people with physical disabilities. The programme also includes the necessary training for the new staff as well as the testing and implementation of new efficiency initiatives. After five years, outcome funders will pay ICRC back if the centres run more efficiently than existing centres measured with the ratio of how many people receive mobility devices per physical rehabilitation professional.

FINTECH AND CROWD-FUNDING

The increased integration of technology in development is likely to be critical to achieving the SDGs, and as such, disruptive technologies are being taken up and piloted by a range of development actors. These technologies include Remote Sensing (RS), Distributed Ledger Technology (DLT), Artificial Intelligence (AI) and Machine learning (ML) and the Internet of Things (IOT).

One of the interesting elements from a recent report Stratigos wrote for DFID is that many of the most significant benefits that new technologies bring to the table relate to the democratisation of participation in different aspects of innovative financing structures through crowdsourcing: small scale investors will be able to participate in a liquid market, ideas for solutions and target areas can be crowdsourced, communities can take part in the design process – and indeed be service providers as well, verification agents can be trusted members of the community, and those wishing to make donations but be sure of the impact of their donation will be able to contribute to outcomes funds. So while crowdsourcing is not a new technology, it does have the potential to be a significant element in the future.

Case Study 2
Sela, a start-up based in Lagos, is leading the development of an affordable housing initiative in East Africa that is forecast to commence in late 2019. Each house will be tokenised. Builders will be paid once satellite imagery and AI-driven computer vision have verified pre-agreed milestones of the build. The title and deed will be housed on the blockchain, and workers will pay rent with tokens or fiat until they have paid off the property and own it themselves – which will again be recorded on the blockchain.

SOCIAL IMPACT INCENTIVE NOTES / SOCIAL SUCCESS NOTES

The Social Success Note (SSN) is a pay-for-performance financing solution to crowd-in return-seeking capital to results-focused impact businesses looking to address the SDG challenges. The SSN is structured as a debt instrument where the borrower pays a sub-market rate of interest which is conditional on them meeting predetermined social or environmental goals. The interest can be further lowered by being covered by a contracted philanthropic donor that also offers to cover the outstanding gap to a market-level rate of interest on the same pay-for-performance basis.

Typically, SSN's have been used by for-profit SMEs with strong social/environmental mission to reduce interest burden and raise the capital in low margin market segment, where they are a less attractive target for commercial capital and scaling is much more difficult. This blended finance mechanism allows donors to achieve more social impact for their money by making it more attractive for investors to fund impact-driven businesses.

In addition to the above-mentioned mechanisms, Islamic Finance has a strong alignment with SDG agenda and thus its instruments, such as Zakat donation, could be considered as a means to pay for demonstrated positive impact, for example in the case of the impoverished children in the countries where it is relevant.

Case Study 3
UBS Optimus Foundation provided a $500,000 loan to Impact Water to expand its work installing low-cost UV-based water purification systems in schools across Uganda. 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 targets, Rockefeller Foundation will pay up to $200,000 to pay both Impact Water's interest and UBS a performance-based return on its investment. The success of the SSN will be based on whether Impact Water manages to provide an additional 1.4 million children with access to clean safe water over the next 5 years.[7]

Recommendations and Next Steps

The best way to structure the financing mechanism to promote the sustainability and child-friendly aspects in infrastructural projects integrates aspects of all of these innovative financing mechanisms. As infrastructural projects usually have a need for a large asset investment, which might be difficult to repay only through outcome payments (as is the case in an impact bond modality), we propose designing a blended finance instrument of "SuRe® Impact Note" following the main basic idea of Social Success Note (see the Impact Water example in Uganda).

[7] *https://cdn.ymaws.com/www.andeglobal.org/resource/dynamic/blogs/20190604_050211_21473.pdf*

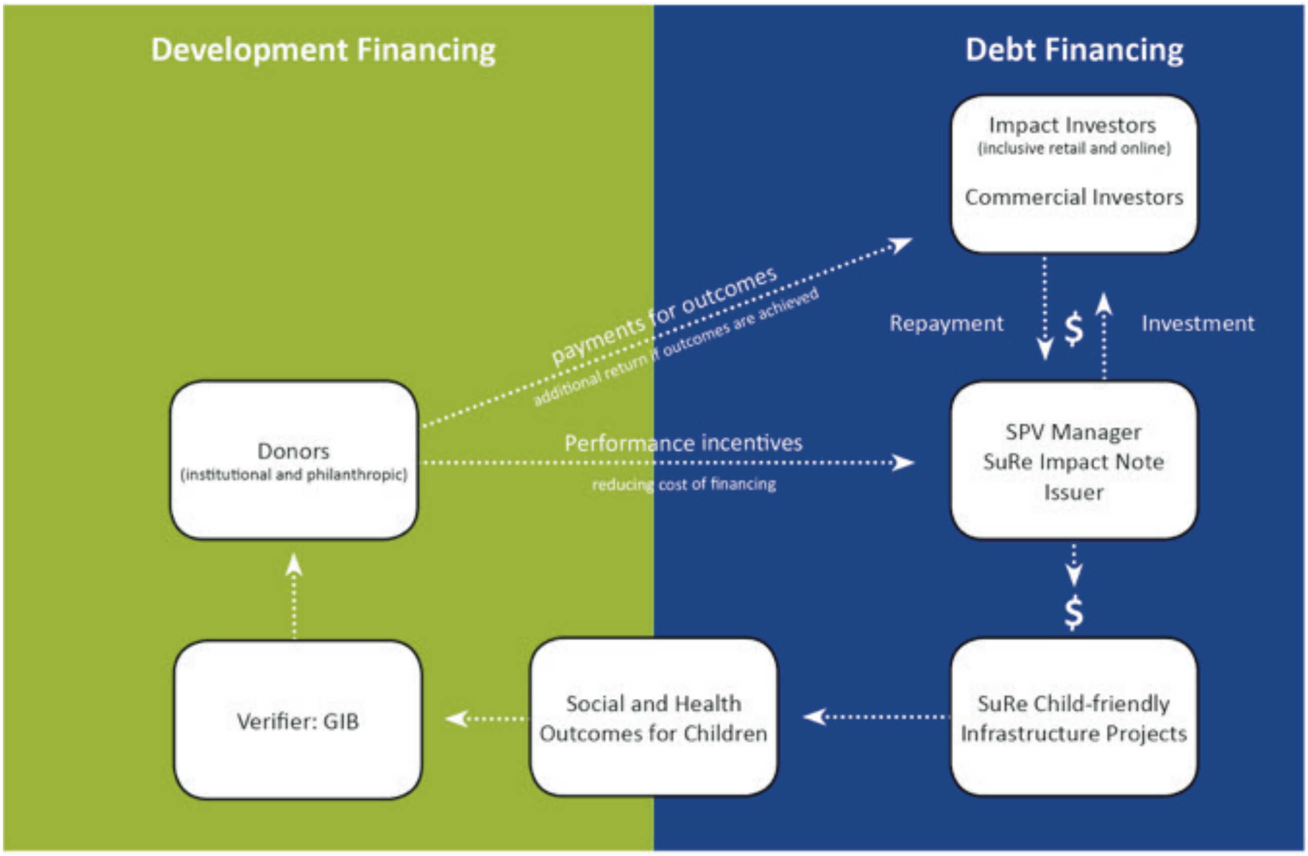

Figure 5 – Potential Structure for the SuRe® Impact Note

The SuRe® Impact Note is blending more traditional debt instruments with development financing (grants) tied to the achieved outcomes for children. This way the grant component will reduce the cost of the debt financing and attract more commercial investors to the sectors and regions, where the financial risks might be higher, and thus enable more investments into SDG sectors.

In the SuRe® Impact Note, the Manager will put together a Special Purpose Vehicle (or similar vehicle) to attract the investments, which can be both commercial and impact-driven investors. The main investment capital covering the infrastructural assets will be repaid back to the investors by the Manager. However, the repayment can be reduced by the outcomes component, which will be paid both to the Manager and the investors by the donors, when the predefined outcomes are achieved. A performance incentive for the Manager would offset initial commercial-rated loan whose interest would be reduced on hitting certain metrics around the child-friendly outcomes (such as rate of the children using the spaces through the additional safety measures implemented). The Manager would pay less interest (or less interest and less initial capital back) to the investors if more social outcomes are achieved. Also, the investors would get an outcomes payment from the donor if the outcomes are achieved and thus a higher return for their investments. Achieving the pre-defined social and health outcomes for children would be a win-win situation for both the SuRe® Impact Note and the investors. However, the details of the financial instrument, such as the rate of return and amounts of the outcomes payments, would be determined during the design phase.

There are other potential aspects that could be added to the instrument if considered feasible. A dual blended finance structure could incorporate grants from donors to pay for Technical Assistance and legal structuring costs during the design phase; and a guarantee to safeguard investor capital from either downstream losses or potential default. A crowd-sourced impact bond could be a part of the financing structure, with a very tightly defined set of outcome metrics with a long-term time horizon that measures children's well-being, social integration and achievement through adolescence. In addition, hosting the pilot on a distributed ledger technology will provide confidence to investors and commissioners that the results will be robust and easily verified using Internet of Things connected remote devices.

In order to progress the SuRe® Impact Note, there will need to be a coordination mechanism to drive next phase of the design process from within the consortium – an organisation like GIB could take that coordination role on bringing different stakeholders, such as project developers, donors and investors, together to design the SuRe® Impact Note.

During the design phase a specific set of projects will need to be identified that meets pre-approved eligibility criteria in order to do a detailed feasibility assessment. GIB-developed SmartScan assessment can assist in selecting those projects with the highest impact potential. We suggest two or three areas of focus, combining diverse geographic areas and types of infrastructure, to provide a diverse enough set of examples to give a robust picture of a range of country and infrastructure project profiles that can be included in the Impact Note fund. During the implementation phase, GIB would take the role of a verifier to validate the outcomes according to the child-friendly features and the set outcomes.

In sum, the SuRe® Impact Note is a feasible and innovative mechanism to attract greater capital to child friendly infrastructure. Whist the precise project-specific mechanics would need to be established, driving additional capital into child-friendly infrastructure developments is a high value for money endeavour allowing our most valuable resource to grow and flourish – and there is no shortage of private capital that would happily support a rigorous and impactful opportunity of this potential scope and value.

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