The ABCs
of Innovative Finance

This glossary was put together by Strat!gos to serve as a reference point for development practitioners and financiers who are committed to using innovative financing strategies to accelerate the 2030 Agenda for Sustainable Development.

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The ABCs of Innovative Finance

Innovative finance as it relates to international development assistance generally has overtones of bringing private markets, private capital and business to bear on tackling social and environmental issues in new, more effective and hopefully more sustainable ways. While this isn't always the case, it's clear from the terms below that productively engaging the private sector in working through solutions to the biggest global challenges has a very big role in the innovative financing landscape.

And it's not hard to see why.

There's a USD2.5 trillion per annum shortfall between what it is forecast will be needed to achieve the SDGs by 2030, and what has been committed. Unlocking the USD210 trillion in private capital markets is critical if we're to succeed.

It sounds obvious, so why hasn't it already happened? The truth is that there's not only a cultural divide between the public and private sectors in how they view the intersection between economic and social issues, there's also a linguistic one. Possibly more like a chasm. And while language brings us together, it can also keep us apart – particularly if the words are familiar but the meanings aren't. Highlighted in the following document are terms that epitomise this duality - terms like equity, risk, investment and even development. Until we understand what our prospective partners are trying to say, it's going to be a very rocky road.

This document is intended to act as a reference point to demystify the terms and contextualise their use in the field of innovative financing for development.

Advance Market Commitments (AMCs): In some ways the forebear of impact bonds, these are agreements that guarantee a price or market for a product upon its successful development, to either mitigate uncertainty or enable frontloading of expenditure based on long-term donor financing pledges. The Vaccine Alliance (GAVI) used the International Financing Facility for Immunisation (IFFIm) to raise more than USD5Bn on the international capital markets from 2006-2014, issuing bonds secured with long-term sovereign commitments to GAVI.

Blended Finance: Blended finance is the mobilisation of both grant monies and private capital towards the achievement of a specific impact investment opportunity. The grant funding can often be used to finance feasibility studies and intervention designs, or to de-risk the investment by providing a guarantee or a first-loss position (see further detail on these terms below!). The grant component of a blended finance structure can also be used to provide technical assistance, capacity building and systems strengthening support both before and during a deal.

Bond: A bond is a financial instrument that enables an entity – usually a government, a company or a financial institution – to raise money through debt capital – in essence, borrowing the money. The entity needing the money now issues the bond and agrees to pay the lenders an agreed interest on a regular basis until the term of the bond expires. This enables the borrower to use the money immediately for current expenditure or long-term investments (for example).

Capital Preservation: The worst-case scenario for any investor is that they only get back the money they invested. This is known as capital preservation. Any investor who doesn't expect or want their capital to be preserved strays into the world of program-related investments (PRIs) and grant making, respectively.

Capital Recycling:

In this space capital recycling refers to using income from outcome payments to offset cashflow requirements. A practical example is a situation where the outcome payments total USD 10 million, but investor risk capital outlay is only USD 4 million. This would lead most observers to conclude that investors stand to gain USD 6 million, or a return of 150%. However, in this example, the cost of activities is USD 9 million. Outcome payments are structured so that there is revenue generated every three months, and these outcome payments are used (recycled) to pay for the coming quarter's activities rather than drawing down on additional capital.

Conditional Cash Transfers:

In order to incentivise certain 'desirable' behaviours, conditional cash transfers are made when either an individual or a service provider meets certain specific criteria. This could be when an expectant mother completes four ante-natal care check-ups, or for children's school attendance, or a number of other areas where these payments can stimulate community and individual investment in human capital.

Convertible Debt:

This is a lower-risk form of investment where the investor wants to reserve the right to change their loan into a shareholding, ie take an equity position, of an enterprise, if the business meets certain targets or shows continued promise.

Debt:

Borrowing money, going into debt, most often using something as collateral, so that current expenditure requirements for operations or for investment can be met. Bonds are forms of debt, as are loans.

Development:

Not to be confused with infrastructure development, International Development lacks a clear definition, but is often linked with human development and international efforts to reduce poverty and inequality and improve health, education and job opportunities around the world. The 17 UN Sustainable Development Goals have given the global community a new framework to focus development efforts on up to 2030.

Development Finance Institution (DFI)/International Financing Institution:

DFIs, as they're commonly referred to, occupy an intermediary space between public aid and private investment, 'facilitating international capital flows.' Distinct from aid agencies in that they focus on profitable investment and operations according more or less to market rules, DFIs nonetheless share a common focus on fostering economic growth and sustainable development. Their mission lies in servicing the investment shortfalls of developing countries and bridging the gap between commercial investment and state development aid. The largest DFI is the European Investment Bank, and other major DFIs include the World Bank, the European Bank for Reconstruction and Development, the Asian Development Bank, the Islamic Development Bank, Inter-American Development Bank, African Development Bank.

Development Impact Bonds:

see Pay-for-Success Financing Mechanisms.

Distributed Ledger Technology (DLT):

Distributed ledgers use independent computers to record, share and synchronize transactions in their respective electronic ledgers, instead of keeping data centralized as in a traditional ledger. The most common DLT is the blockchain, which is used as the building block for cryptocurrencies, identification, e-governance, commerce and a growing number of use cases which will likely transform the entire global trade, finance, identity and commerce systems.

Due Diligence:

Investors conduct due diligence before entering into a financial agreement. Governments and donors use due diligence processes to ensure their contractors aren't hiding ties to organised crime or terrorist organisations. Companies and organisations do due diligence on new hires to make sure there's no history of illegal or unethical behaviour. In all these cases, it's about really getting to know who you're getting involved with before there's a legal commitment that it will be difficult and timely to unwind, and which can cause serious financial and reputational damage.

Environmental, Social and Governance (ESG) Criteria:

ESG is a set of standards that investors can use to screen potential investments. Environmental criteria look at the environmental impact of a company. Social criteria focus on how a company manages its relationships with its employees, customers, partners and service providers. Governance criteria deals how a company's operations are managed: promotion process, executive pay, audits, internal controls and shareholder rights.

Evaluation:

A process to assess the relevance, efficiency, effectiveness, impact and sustainability of a development program. Most evaluations are conducted at the end of a program. For result-based financing mechanisms, evaluations are conducted by independent evaluators so that outcome metrics can be assessed and payments to investors by outcome funders released.

Equity:

Equity is one of those terms that really highlight the difference between the development community and the finance community. For the development community equity is about ensuring access to goods, services and resources for all members of a population, regardless of socio-economic status, gender, religion, ability, gender or sexual identity, political belief, etc. For the finance community, equity refers to having partial ownership of an asset which makes up part of the total capital of the asset.

First-Loss Capital:

In our context, first loss capital is a socially or environmentally driven credit enhancement tool provided by a DFI, philanthropic investor or grant-maker that agrees to lose their money before other investors if the investment doesn't work out as forecast, in order to catalyse the participation of co-investors that otherwise would not have entered the deal – usually more mainstream investors that would otherwise find the deal too risky. It's a form of de-risking noted above under blended finance.

Grant makers:

Governments, donors, foundations or agencies whose only return expectation is of a social or environmental – not financial – nature. Grant makers are an essential partner in blended finance solutions.

Guarantees:

Guarantees are another de-risking tool, and again a frequent part of blended finance solutions. If there are concerns that there's a significant risk of the investment failing, or a loan not being repaid, a guarantee can be put in place so that the investors are certain to recoup at least some of their money. Government agencies (DFIs in the case of developing countries) can guarantee loans to enable borrowers to access capital without putting excessive risk on the lending institution. In addition to default guarantees, performance guarantees can be put in place for pay-for-success financing mechanisms.

High net-worth individuals (HNWI):

A classification used for an individual or a family with high net worth. Although there is no precise definition of how rich somebody must be to fit into this category, high net worth is generally quoted in terms of liquid assets over a certain figure. The exact amount differs by financial institution and region. HNWIs are an important part of the impact investment ecosystem, as they are increasingly interested in double and triple bottom line returns (see investors). They're often regarded as more flexible and able to make decisions more quickly than institutional investors – so a much-sought after (but rare) resource!

Impact:

Another term which is often confusing in a conversation between development folks and finance folks. For development practitioners, impact has a very particular meaning along the spectrum of a theory of change – it is the highest-level target, involving for example decrease in mortality rates or increase in economic empowerment across a population. For finance professionals impact is simply a term used to denote something positive in social or environmental terms. This definition of impact doesn't necessarily measure inputs, outputs, outcomes or impact, and indeed might involve no measurement at all, but rather a blanket term for an ESG investment fund.

Impact Evaluation:

Impact evaluation is still very much aligned with the development practitioner interpretation of impact – that is to say, an impact evaluation is a substantial piece of research that involves rigorous data collection, usually collecting data before, during and after the activities. Often methodologies such as randomised control trials (RCTs) are used. Because of the complexity and resources involved, leading to substantial cost, most impact evaluations are funded outside of any innovative financing mechanism, and complement the innovative finance work by providing hard data on whether the intervention and mechanism were effective or not.

Impact Investment:

Coined by Judith Rodin and the Rockefeller Foundation in 2007, Impact Investment has become a very popular term. Most serious definitions of an impact investment involve two critical terms: intentionality; and measurement. In order of an investment to really be an impact investment, the investor should intend to achieve certain social or environmental targets and make it explicit what the targets are. The investor (or intermediary, or external party) then must measure and report on both the commercial return as well as the social or environmental returns as part of routine reports. In reality, many funds, investors and entrepreneurs use the term as a new marketing term to ride on the wave of excitement about the space.

Impact measurement:

This is a notion that often confounds finance professionals. In international development it is not uncommon for 7-10% of multi-million dollar contracts to be spent on monitoring and evaluation. In innovative financing solutions that harness private capital, this would erode a very large portion of any financial return, and so much lighter-touch measurement approaches need to be developed. A variety of tools have been collated by the Global Impact Investment Network (GIIN), but so far, no standard has been identified, and most large-scale initiatives tend to develop their own approach. Often the impact measurement piece will sit outside of the deal and be funded by a grant-making organisation to add to the global body of knowledge on what works and what doesn't. As the field matures, there will need to be standardisation to enable common reporting of impact, in the same way that an annual financial report is able to be commonly understood.

Independent verification agency:

In a pay-for-success financing mechanism, where payment is determined by the achievement of pre-agreed outcome metric targets, it is essential that third-party agency verify results to trigger payments. This agency is usually paid for outside of the actual mechanism, with the cost borne by the outcome funder. The core responsibility of this agency is not to undertake an impact evaluation but rather to function more or less as an auditor of results.

Innovative Finance:

Innovative finance (or InnFin) can mean different things to different people, but most definitions clearly include engaging non-traditional partners, which generally means partners in the private sector, including corporations, the business community, and investors. Innovative finance can include impact investments, public private partnerships, results-based financing mechanisms, outcomes-based contracts, impact bonds, challenge funds, results-based loans, advance market commitments, conditional cash transfers and prizes. Islamic finance is also becoming integrated into innovative finance approaches. More and more, financial technology – or fintech – is playing an important enabling role in innovative financing initiatives.

Intermediary:

There's no one specific attribute which defines an intermediary – they're the in-between players who act almost as interpreters, managing relationships between social enterprises, financial institutions, service providers, investors, and often performance managers and verification agencies as well. The intermediary role usually includes one or more of the following set of activities: raising capital, structuring the deal, establishing a company or special purpose vehicle (SPV), managing partners, receiving outcome payments, paying investors, conducting performance management and monitoring service providers.

Internal Rate of Return (IRR):

IRR refers to the compound return of a series of cash flows over a specific period (usually several years), and it is used as one of the two main measures of investment returns. This is a metric that is used in capital budgeting to measure the profitability of potential investments. The term "internal" refers to the fact that the calculation does not incorporate external factors such as interest rate or inflation.

Investors:

In this context, investors use their own or others funds to provide money to enterprises or financial mechanisms with a view to driving social change while at the same time receiving a financial return. This is referred to as a double-bottom line, or where environmental issues are considered, a triple-bottom line. Generally, these investors are known as impact investors, social investors, or social impact investors, although there is a push at various levels for these terms to be dropped so that there is no distinction between these types of investors and mainstream investors. The rationale driving this push is that it is the mainstream institutional investors who control the majority of global capital, and the fear is that by emphasising the social impact elements of investing it will provide a hindrance to unlocking the USD 210 trillion in these markets. On the other side of this argument is that there is at least anecdotal evidence that even mainstream investors are becoming more sensitised to the need for considering social and environmental factors.

Islamic Finance:

A system of banking or banking activity that is consistent with Islamic law (Sharia) principles and guided by Islamic economics. Islamic law prohibits the collection and payment of interest. In addition, Islamic law prohibits investing in businesses that are considered unlawful, or haram (such as businesses that sell alcohol or pork, or businesses that produce media such as gossip columns or pornography, which are contrary to Islamic values).

Liquidity:

The problem with putting money into investments is that you can't always get your money out if you need it – this is the problem of liquidity. Particularly in pay-for-success financing mechanisms, no second-hand markets exist, so it is not possible to sell your investment and free up your money.

Mandate:

An investment mandate covers off the geographic and sectoral focus of an investment fund, as well as the types of financial instruments and asset classes that they will invest in. It is essential an investment strategy.

Market-based rate of return:

The Holy Grail for Impact Investors – this essentially represents the average return on the global capital markets (or a specific exchange or country). There's a general sense that impact investments have to sacrifice a market-based rate of return as a trade off for the social or environmental impact. Some disagree with this, for the same reason that the term Impact Investment has detractors – there's an increasingly common view that 'market' returns are too high, and there's a compromise point somewhere in between.

Outcome:

Like the term impact, using the term outcome can provide for a long discussion between different actors. In development language, an outcome is the result of a number of outputs being successfully delivered, which should lead to the impact target. When used more casually, it is simply the result of something happening!

Outcome metrics:

This has quite a specific meaning in the innovative financing space, where it is associated with pay-for-success financing mechanisms. In these mechanisms the Outcome Funders, intermediary and investor(s) need to negotiate and agree where along the Theory of Change (ToC) the payments will be triggered. On the Outcome Funder side, the motivation is to base payments as high up the ToC towards genuine impact indicators as possible – and on the investor side, the motivation is to base the payments as far down the ToC as possible, towards inputs and outputs, that they know they have control over. Agreeing on the outcome metrics, including the payment triggers and the costs, is the most complex part of structuring a pay-for-success financing mechanism, and extreme care needs to be taken to ensure that the metrics do not result in perverse incentives – that is to say that in the pursuit of progress towards the payment triggers, the Service Providers are for example inadvertently incentivised to ignore critical health or human rights issues.

Outcome Funder:

Again, specific to pay-for-success financing mechanisms, the Outcome Funder - also referred to in different contexts as the Commissioner or Outcome Buyer – is the government, donor, or foundation that (ideally) identifies the social challenge, models out potential savings, proposes the outcome metrics, and then agrees to pay for the outcomes when the targets are met. The Outcome Funder generally pays for the Independent Verification Agency.

Patient Capital:

Most investors want a reasonably quick return on their investment – generally around 2 years. Patient capital refers to a situation whereby the investor is happy to take a much longer-term position.

Pay-for-Success Bonds:

see Pay-for-Success Financing Mechanisms.

Pay-for-Success Financing Mechanisms:

There is a great deal of confusion around the terminology of these mechanisms. In the United Kingdom, where the mechanism was first deployed, they are known as Social Impact Bonds, or SIBs. This is the most common term in Continental Europe as well. In Australia they're called Social Benefit Bonds (SBBs). In the United States of America, they're often known as Pay-for-Success Bonds. They are often referred to as Development Impact Bonds, or DIBs, in emerging economies.

The reality is that they are not bond instruments as described above. And they don't pay based on the achievement of impact as development practitioners know it. And a pay-for-success financing deal can be launched in an emerging economy without the characteristics of what most of the global community refer to as a Development Impact Bond.

More accurately, they are agreements whereby private investors provide upfront risk capital for the delivery of social services by service providers, and the investors are repaid with a success premium by an outcome funder if the pre-agreed targets are met.

In broad terms, a SIB, SBB or Pay-for-Success Bond involves a government entity as the outcome funder; the difference between these and a DIB is that a DIB involves a third-party – such as a donor, corporation or foundation – ie not the host government – commissioning or paying for the outcomes. It is entirely feasible for a pay-for-success financing mechanism to be structured in an emerging economy with the host government as the Outcome Funder.

Payment-by-Results (PBR):

PBR refers to a program where the funder only pays for a service provider to deliver predefined outputs or outcomes – not for inputs.

Payment Schedule:

Another term generally associated with the pay-for-success financing mechanism in this field. It relates to the number and frequency of payments from the Outcome Funder. This is an important facet of reducing the cost of capital and making these types of mechanisms cost effective compared to traditional grant programs.

Performance-based Contracts (PBC):

Contracts or grant agreements where payments are disbursed on accomplishment of pre-determined results. These arrangements are principally between funders and service providers. They have been criticised for making it financially untenable for smaller non-state actors to participate in the programs, as these actors do not have the wherewithal to take the risk of self-financing. This conundrum has been a driver of the pay-for-success financing mechanism involving private capital.

Public Private Partnerships (PPPs):

PPPs are generally thought to be large-scale infrastructure initiatives where a developer takes on the cost of constructing a publicly sanctioned bridge or a road or a power plant and then recouping the costs of the construction over a period of time in partnership with the local government. Now PPPs have a broader definition, encompassing any partnership where the private sector and private capital work in a formal contract with the public sector. Pay-for-success financing mechanisms are an excellent example of this new definition of PPPs; a long-term contract between private investors and a public or philanthropic entity for the provision of a public service in which the investors bear significant risk and management responsibility, and their remuneration is linked to performance.

Political Risk Insurance:

An insurance policy for investors to protect them against sudden change in policy that could lead them to lose their investment. PRI can also protect them against defaulting governments or even if political violence negatively impacts their investment. This also falls under the definition of Guarantees – specifically in this case of Sovereign Guarantees.

Prizes:

A competitive grant procedure where financial rewards are awarded to one or more competitors that are successful at solving an identified global challenge.

Program-Related Investment (PRI):

Many foundations increasingly have part of their annual budget that they can use to invest in social enterprises and charitable activities to stimulate social enterprise with the prospect of a return of the capital deployed. These PRIs do not expect anything approaching a risk-adjusted rate of return, and in some circles are considered more like grants or, at best, soft loans.

Recoverable Grants:

A recoverable grant is a loan that can be converted to a grant under certain pre-agreed conditions. It's another form of soft loan.

Return On Investment (ROI):

Basically the difference between the investment and the return. ROI is sometimes flipped to refer to Realisation of Impact.

Results:

See Impact and Outcome. This term is used in Results-based Financing (RBF) and Payment-by-Results (PBR). Mostly these terms are used interchangeably along with Impact Bonds and Outcomes-based Contracts, but there are nuances which can lead to misunderstanding. When private capital is being used, the most appropriate terminology to use is pay-for-success financing mechanisms. Otherwise RBF and PBR are essentially the same, whereas the terms Impact Bonds and Outcomes-based contracts should be erased from the lexicon.

Results-Based Financing (RBF):

RBF refers to a program where the funder sets incentives – usually financial – for a service provider to deliver predefined outputs or outcomes and rewards the achievement of these results.

Returnable Capital:

Any mainstream investor would expect any capital they invest to be returned – at least to preserve the initial (principal) outlay. This is a relatively new concept for donors and foundations, which have generally been focussed entirely on disbursement of grants. Increasingly, there is discussion around how development agencies can also deploy returnable capital for public good.

Risk:

Another pain point when development folk and finance folk come together. When a development practitioner talks about risk, they are generally thinking about risks to program delivery. When an investor thinks about risk, they're wondering what their chances of recouping their money is.

Risk-Adjusted Rate of Return:

The reality is, every decision we make is calculated on whether the outcome will cost us more than it's worth. The same can be said a thousand-fold over for an investment committee when presented with an investment proposition. A quantifiable multiplier that takes into account the likelihood of being able to recoup a return from the investment is essential for any mainstream investor/investment fund. At this point, many impact investments rely on philanthropic capital, because the risks involved of working in emerging economies, in nascent or disruptive industries, and at the bottom of the pyramid are simply too complex to be able to quantify. In order to scale what are today regarded as impact investments, a standardisation of risk ratings needs to take place.

Service Provider:

Front-line agents providing social services to communities.

Social Bonds:

see Pay-for-Success Financing Mechanisms.

Social Benefit Bonds:

see Pay-for-Success Financing Mechanisms.

Social Impact Bonds:

see Pay-for-Success Financing Mechanisms.

Soft Loans:

These can range from below-market interest rates, to generous repayment schedules, to potential write-offs if pre-agreed targets aren't met.

Special Purpose Vehicle (SPV):

These can be any fit-for-purpose structure that enables the secure and legal transfer and management of funds with a specific mandate. Sounds very technical, but, it is just any legal agreement that all parties are happy provides them the comfort that they won't be cheated.

Technical Assistance:

Any advisory support purposely intended to support any and all aspects of a deal, before, during and potentially after it takes place.

Term Sheet:

The Term Sheet is much beloved by the finance and investment community. It isn't a 50 page narrative, it isn't a power-point slide with lots of graphs, it's a document of a couple of pages which synthesises the critical points of data that investors want to know: the product, the terms, the geography, the size, the return expectation, how much it will cost to stand the investment up, cashflow forecast, and in our context, what the impact indicators are and how they will be measured.

Theory of Change (ToC):

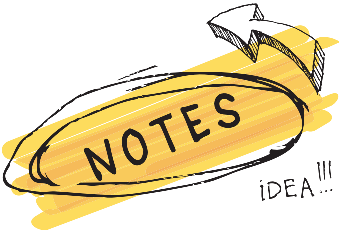
This is a schemata describing and illustrating how a set of activities, or inputs, will contribute to the outputs that lead to the desired social outcome of a development program, and eventually the impact that is expected. The ToC is a powerful tool for Outcome Funders and Investors or Intermediaries to utilise when negotiating the outcome metrics in a pay-for-success financing mechanism.

Unconditional Cash Transfers:

An interesting and relatively new approach that provides vulnerable populations with the wherewithal to address the gaps in resources in their communities in their own way, without tying the disbursement of cash or resources to a specified set of behaviours.

Volatility:

Global markets are not only volatile, but they generally tend to follow each other – hence the booms and busts we are familiar with. This is one of the least talked about motivators for institutional investors to look to impact investments, and instruments like pay-for-success financing opportunities: they are subject to their own volatile patterns, but these have generally no correlation with global markets, so taking a portfolio approach, investing in these types of opportunities spreads risk.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IMPACT
BONDS
72%
19%
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