

# Cheaper by the Dozen:

Reducing Costs in Development Impact Bonds

A briefing note produced as part of the independent evaluation of the Department for International Development's Development Impact Bond Pilot Programme



This briefing paper focuses on the costs of setting up and implementing Development Impact Bonds (DIBs). It is drawn from the findings in the Research Wave 1 Evaluation Report as part of the Independent Evaluation of the Department for International Development (DFID) DIBs pilot programme, undertaken by Ecorys. The evaluation found there were additional costs to setting up and implementing DIBs, when compared to the costs that would be expected to be incurred under a fee-for-service or payment by results (PbR) contract. The median estimate cost for setting up and implementing a DIB, across the four DIBs examined, was \$1,170,792 (ranging from \$569,942 to \$2,016,976).

Set up costs were generally higher because of the additional legal and financial advice necessary. Stakeholders projected that implementation costs would be higher because of external performance and project management costs, and verification costs (though verification costs would also be necessary under a PbR contract).

Importantly, the set-up and implementation costs did not rise in proportion to the size of the DIB. This suggests that some impact bond costs are 'fixed'. This supports the argument made by some that scaling impact bonds is one solution to reducing the relative size of transaction costs. Also, it lends weight to discussions that outcomes funds (where multiple impact bonds are funded through one fund) could reduce relative transaction costs as, for example, the legal advice only needs to be received once for multiple impact bond deals. Impact bonds could, therefore, be 'cheaper by the dozen'.

Furthermore, the majority of stakeholders felt that some of the DIB costs were 'one off' costs because stakeholders were developing DIBs for the first time. For example, stakeholders involved in the QEI DIB estimated that a quarter of additional costs absorbed by outcome funders/investors were one-off costs as opposed to ongoing costs. Stakeholders identified a number of ways in which they thought DIB costs could be reduced in future iterations, and these are covered in this briefing paper.

Whilst there was a widely-held view that DIB costs could be reduced, we would caution against the extent of this reduction. There was a strong view that technical costs could be brought down, but a lot of the costs are also driven by relational factors – as in, the time it takes to bring stakeholders together and reach collective decisions. Impact bonds by their very nature bring together additional stakeholders when compared to other contracting models, and so it is unlikely the relational costs could be reduced to any significant degree. Indeed this was the experience in the Quality Education India (QEI) DIB, which built on the Educate Girls DIB. Stakeholders felt the technical aspects of the impact bond design were achieved in a shorter timeframe because stakeholders were able to build on the templates / lessons from the Educate Girls DIB. However, as the DIB involved more stakeholders than the Educate Girls, DIB stakeholder management time (and therefore relational aspects) actually increased. Furthermore, there is a risk that, in a bid to drive down costs, critical elements of the impact bond design are removed, which could inhibit its benefits. In particular,

impact bonds in the UK have tended to move away from including rigorous estimates of the counterfactual in the outcome payment structure, some of this driven by the desire to reduce costs. However, it would seem logical that any contract commissioning for outcomes ensures those outcomes are measured in a rigorous manner. In removing some costs you therefore also risk removing some of the value of impact bonds.

It is also important to note that the investor returns are not a fixed cost, but rather are linked to the performance of the DIB – if the DIB performs well the returns paid to the investor will be higher, but if it does not perform well the returns will be lower. In this way the returns can be seen as a payment for additional and improved outcomes, and to compensate for the investors' risk and the cost of capital.

At the end of this briefing paper we include a list of recommendations on how transaction costs could be reduced in future impact bonds. Central to this is replication and transparency: technical costs could be reduced by building on the models developed by other impact bonds, but in order for this to be possible information on these models needs to be publicly available.

The newly-developed impact bond knowledge platform should go some way to contributing to this, as it includes a global database of impact bonds which have launched.

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This briefing paper is drawn from the findings in the **Research Wave 1 Evaluation Report as part of the Independent Evaluation of DFID's DIBs pilot programme**, undertaken by Ecorys. The DIBs pilot programme runs over a period of almost six years, from June 2017 to March 2023. DFID has allocated GBP 6.3 million of funding for the three projects under the DFID-supported DIBs pilot programme: ICRC: Humanitarian Impact Bond for Physical Rehabilitation; Village Enterprise: Micro-Enterprise Poverty Graduation Impact Bond; and support to British Asian Trust: to design impact bonds for education and other outcomes in South Asia (which includes the Quality Education India DIB). The GBP 6.3 million of funding forms a proportion of the total value of the three DIBs, which are also co-funded by other donors. The DFID DIBs team engaged in the design process of each DIB, but DFID's funding is primarily allocated to paying for outcomes, performance management and results verification, rather than the costs of setting up these first DIBs.

Since the evaluation inception phase, a fourth DIB, the Cameroon Cataract Bond, was added to the evaluation. This is not a DFID-funded pilot, but has been added to the evaluation to increase the number of DIBs under examination and therefore to strengthen the comparative analysis and findings. These DIBs are summarised in **Table 1**.

This paper focuses on the costs of setting up the four DIBs, and projected implementation costs. It includes estimates of the additional costs of setting up and implementing DIBs compared to fee-for-service and PbR) contracts, what drives these additional costs and stakeholders' views on how costs could be reduced in future DIB deals.

DIB costs are estimates provided by stakeholders. It should be noted that this exercise was done retrospectively, and that a standardised cost template was not used by stakeholders. Stakeholders varied in terms of the extent to which costs were captured throughout the process, with staff time and pro-bono support especially challenging to fully capture. The figures provided by the different DIBs were too partial to enable a meaningful comparison. Nonetheless, the figures provide useful information as to the types of costs necessary for developing and implementing DIBs.

## What is a DIB? /

A DIB is a mechanism for drawing external finance into PbR projects. In a DIB a donor commits to paying for development results if and when they are achieved. A service provider steps up to deliver the prescribed results. The key difference from standard PbR is that a DIB brings in third party "investors" who provide the service provider with the investment/working capital needed to deliver activities designed to achieve the results. Under the DIB model, the investor also takes on a portion of the financial risk associated with failing to deliver the prescribed outcomes.

## DIBs examined as part of evaluation /

The four DIBs examined as part of the evaluation are summarised in Table 1. Further information is available in the Research Wave 1 Evaluation Report.

**Table 1: DIBs examined as part of evaluation**

<b>International Committee of the Red Cross (ICRC) Humanitarian Impact Bond (HIB) for Physical Rehabilitation</b>	<b>Quality Education India (QEI) DIB</b>	<b>Village Enterprise Micro-enterprise Poverty Graduation Impact Bond</b>	<b>Cameroon Cataract Bond</b>
<p>This DIB funds the building of three new physical rehabilitation centres in Mali, Nigeria and Democratic Republic of Congo (DRC). As a part of the HIB, ICRC is also piloting efficiency improvement measures testing and building a Digital Centre Management System (DCMS).</p>	<p>This DIB aims to offer a solution at scale to the learning crises in India, by funding a range of high performing service providers to improve learning outcomes for more than 300,000 primary school aged children. There are three service providers involved, delivering different interventions.</p>	<p>This DIB aims to raise the income levels of a minimum of 12,660 households through Village Enterprise's microenterprise development program, known as a Graduation program. It aims to equip its beneficiaries with the resources to create sustainable businesses.</p>	<p>This DIB funds sight-restoring cataract surgeries, with the overall aim of enabling the Magrabi ICO Cameroon Eye Institute (MICEI), the first eye care hospital in Cameroon, to reach self-sufficiency in five years. The loan aims to expand the market reach and provide eye surgeries for up to 18,000 low- and middle-income patients at a low cost.</p>
<p>Up to CHF 26.09 million of outcome payments will be made based on improvements in the Staff Efficiency Ratio (SER), from the beginning to the end of the HIB, calculated by the number of beneficiaries having regained mobility thanks to a mobility device, divided by the number of local rehabilitation professionals. The outcome funders are the Swiss, Belgian, Italian and UK governments and La Caixa Foundation. The cornerstone investor is New Re (a subsidiary of Munich Re, a reinsurance company), alongside six other investors.</p>	<p>Up to a maximum of USD 9.2 million of outcome payments will be made based on improvements in learner outcomes, compared to a comparison group. There are five outcomes funders, including Michael &amp; Susan Dell Foundation (MSDF) as the lead outcome funder. The UBS Optimus Foundation raised the investment from donations.</p>	<p>Up to USD 4.3 million of outcome payments will be made, mainly tied to increases in household income. The outcome funders are DFID, USAID and an anonymous donor. This capital has been provided by nine investors, including the Delta Fund as lead investor.</p>	<p>Up to USD 2.8 million of outcomes payments will be made, including USD 2.68 million in repayment of principal and interest to lenders and USD 0.12 million in incentive payments to the hospital, tied to the achievement of three outcomes (number of cataract surgeries, quality of surgery and financial sustainability of the hospital). The outcome funders are the Conrad N. Hilton Foundation, The Fred Hollows Foundation and Sightsavers. The investors are the Overseas Private Investment Corporation (OPIC) and the Netri Foundation.</p>

## The costs of setting up and implementing DIBs /

All stakeholders confirmed there had been additional costs - either actual, in kind or pro bono – for staff time and consultancy in designing and setting up the DIBs, compared to if the projects had been funded through a fee-for-service or PbR contract. There were also projected additional costs for implementing the projects through DIBs. Across the four DIBs, the median estimated additional cost of funding the project through a DIB rather than fee for service contract was \$1,170,792<sup>1</sup> (ranging from \$569,942 to \$2,016,976). This included median additional set up costs of \$401,884 (ranging from \$363,384 to \$1,259,476) and median implementation costs of \$768,908 (ranging from \$757,000 to \$1,139,970).

In addition to this, there were median maximum potential investor returns of \$750,000 (ranging from \$649,333 to \$6,464,000).

It is also important to note that the investor returns are not a fixed cost, but rather are linked to the performance of the DIB – if the DIB performs well the returns paid to the investor will be higher, but if it does not perform well the returns will be lower. In this way the returns can be seen as a payment for additional and improved outcomes, and to compensate for the investors' risk and the cost of capital.

These costs tended to be incurred by outcome funders and service providers. The most significant costs related to the investor returns that will be paid (either by the outcome funder or service providers). **Table 2** provides further detail on these costs.

<sup>1</sup> Costs across the DIBs have been converted into USD to allow comparability. Exchange rates correct as at 18/07/19.



**Table 2: Additional costs of setting up and implementing DIBs**

Cost categories	Costs (including actual, budgeted, in-kind and pro-bono)	Paid for by
<b>Design and set up (estimated costs already incurred)</b>		
<b>Staff time set up</b>	Where estimated, this ranged from USD 150,000 to USD 490,000. Otherwise, stakeholders described the significant time commitment e.g. staff time over two years.	Generally funded by organisations (investors, outcome funders, service providers) providing staff time 'in-kind', as well as advisors and intermediaries providing pro-bono time. In some cases funded by a separate grant, e.g. ICRC received a grant for the set up phase from the Government of Netherlands.
<b>External advice on contract design</b>	Three out of the four DIBs estimated to be just over USD 250,000, while one DIB estimated this to be USD 687,000.	Paid for by the outcome funder or funded by a separate grant except for QEI where Investor funded these costs.
<b>Legal and financial advice</b>	Not all these costs were included in budgets. Where costs had been captured, these ranged from USD 50,000 to USD 120,000. However, in most cases this underestimated the full cost as not all the pro-bono hours had been recorded.	In general, these were pro bono. Where services were procured rather than provided pro bono, the costs were funded by the outcome funder or funded by a separate grant.
<b>Implementation (projected costs, not fully incurred)</b>		
<b>Contract management costs</b>	These costs were reflected in budgets and ranged from between USD 52,500 to USD 670,000	Paid for by the outcome funder or funded by a separate grant. In one case performance management costs are (QEI) co-funded by investor.
<b>Verification</b>	These tended to be contracts with third parties but varied in size with two DIBs using validated administration data having lower verification costs e.g. around USD 50k and two with larger costs around USD 500-600k (involving experimental / quasi-experimental approaches).	Paid for by the outcome funder or funded by a separate grant.
<b>Investment vehicle related costs e.g. Escrow and legal fees</b>	The types of costs under this category varied between DIBs depending on how they have been set up. Total costs under this category range from USD 30k to USD 105k.	Paid for by the outcome funder or funded by a separate grant.
<b>Maximum payments to investors (projected costs, not yet incurred)</b>		
<b>Maximum payments</b>	These ranged from USD 650k to USD 6.4m.	Paid for by the outcome funder.

## Comparing DIB costs to other contracting models /

Stakeholders identified that some of the design and set-up costs were unique to DIBs (e.g. contracts requiring legal and financial consultancy), but that others were commonly seen in other similar programmes, particularly with a PBR or output-based contract

(such as ongoing costs of performance management, project management and verification). **Table 3** below provides a brief discussion of the types of costs, and the extent to which these would be expected in a PbR contract.

**Table 3: Comparing DIB costs with PbR programme costs**

Activities linked to additional DIB costs	Comparison between DIBs and PbR
<b>Design and Set Up Phase</b>	
<b>Staff time</b>	Additional range and number of stakeholders involved in DIBs means that more costs are expected in the set up of a DIB.
<b>External advice on contract design</b>	The complexity of DIBs and lack of standard templates mean that this is more of a feature within DIBs.
<b>Legal Costs</b>	
<b>Implementation Phase</b>	
<b>Performance and project management</b>	Expected additional costs linked to both DIBs and PbR projects. However, external performance and project management costs are more common features of DIBs, which are expected to increase costs in this area.
<b>Reporting</b>	Expected that this will be a feature in both DIBs and PbR funded projects, though reporting in DIBs is likely to be more extensive, given the range of stakeholders involved.
<b>Verification</b>	Expected costs to be similar across PbR and impact bonds. However, impact bonds feature additional stakeholders, such as investors, which are interested and tend to feed into the selection of the verification approach.
<b>Return to investors</b>	Not a PbR cost.

## Relationship between set up and implementation costs and size of DIB /

A key finding was the costs (with the exception of returns to investors) did not seem to be proportional to the size of the DIBs, and that there seemed to be a certain level of 'fixed costs', which will have implications for the optimal size of the DIB. Cost drivers involved a variety of factors, unlinked to the size of the DIB.

## Cost drivers influencing DIB costs /

Cost drivers were identified by stakeholders to help understand which elements of the DIB were the most time-intensive or expensive. There was a large degree of overlap across the DIBs, as summarised in **Table 4**. All the DIBs identified legal and financial advice as a major cost driver, taking significant staff time and expertise. Engaging outcome funders and raising finance from investors were also identified by three out of the four DIBs. Other areas of overlap included the number of organisations that were involved and the negotiations, particularly being the first time.

**Table 4: Cost drivers influencing DIB costs**

Cost drivers	Legal, governance	Engaging outcome funders	Number of organisations to coordinate	Negotiation of agreements	Raising finance	Service provider selection process
ICRC HIB	✓	✓	✓	✓		
QEI DIB	✓	✓	✓		✓	✓
VE DIB	✓	✓		✓	✓	✓
Cataract DIB	✓				✓	

# /How costs could be reduced for future DIBs: 5 steps

A number of stakeholders commented that the DIB was complex to design and expensive to set up. Stakeholders pointed out that this is always the case when launching a new instrument, and that is not necessarily an issue as long as the initial investment can be leveraged thereafter by launching additional DIBs.

Stakeholders expected some of the DIBs costs would reduce for future DIBs. For example, stakeholders involved in the QEI DIB estimated that a quarter of additional costs absorbed by outcome funders / investors were one-off costs as opposed to ongoing. Stakeholders identified a number of ways in which they thought DIB costs could be reduced in future iterations, and these are summarised on the following page.

## Identifying metrics & structuring payments /

### 1. **Develop and share information on metrics, rate cards and interest rates:**

A large amount of time and resource was spent on agreeing outcome metrics. Stakeholders reported that they struggled to find information on potential similar programmes (such as PbR) that they could use as comparison. Similarly, stakeholders reported challenges in determining what would be an acceptable level of return to investors because of limited publicly-available data to use as benchmarks. A solution to both of these challenges would be greater transparency around what outcomes and interest rates have been used in similar projects, which will help to inform and benchmark the price of risk transfer and working capital in the future. The newly-developed impact bond knowledge platform should go some way to contributing to this, as it includes a global database of launched impact bonds, including information on outcomes metrics, payments and interest rates.

### 2. **Draw on private sector expertise:**

Another solution to improving how risk is being priced is to learn more from private sector expertise. In the ICRC HIB the private investor Munich Re was able to model the risk costs by using internal insurance models on ICRC historical data. Stakeholders felt this capability was not common in the development sector, and drawing on private sector expertise could be helpful.

### 3. **Utilise metrics already used in the sector:**

Some of the DIBs examined tied payments to new measurement tools not currently used in the relevant sector. Whilst this increased the robustness of the measurements, it created challenges and raised costs linked to educating service providers and finding appropriate comparison groups. Costs would have been lower if the DIBs used pre-established and well-understood measures.

- 4. Introduce competition for service providers:** Some of the DIBs used competitive processes to select appropriate service providers, but others did not. Stakeholders felt that introducing competition could drive down costs of service providers.

## Stakeholder management /

- 5. Focus on effective stakeholder management:** As Table 4 shows, one of the main drivers influencing the DIB transaction costs is stakeholder management. Therefore, managing stakeholders effectively has the potential to bring down transaction costs. In the four DIBs examined, effective stakeholder management meant:
- a.** Strong collaboration across stakeholders, drawing on each other's expertise and strengths.
  - b.** Involving the right number and balance of stakeholders.  
The general view was that the number of stakeholders tended to increase the project management time needed and complexity around negotiations. Limiting the number of stakeholders involved to a necessary minimum in pilots can limit complexity and the associated costs.
  - c.** Clearly defining roles are from the start.

## Conclusions /

This briefing paper has provided an overview of the costs of setting up four DIBs examined as part of the DFID DIBs evaluation.

One of the most important findings is that the set-up and implementation costs did not rise in proportion to the size of the DIB. This suggests that some impact bond costs are 'fixed'. This supports the argument made by some that scaling impact bonds is one solution to reducing the relative size of transaction costs. Also, it lends weight to discussions that outcomes funds (where multiple impact bonds are funded through one structure) could reduce relative transaction costs as, for example, the legal advice only needs to be received once for multiple impact bond deals. Impact bonds could, therefore, be 'cheaper by the dozen'.

Furthermore, the majority of stakeholders felt that some of the DIB costs were 'one off' costs because stakeholders were developing DIBs for the first time. Stakeholders identified a number of ways in which they thought DIB costs could be reduced in future iterations, and these are covered in this briefing paper.

Whilst there was a widely-held view that DIB costs could be reduced, we would caution against the extent of this reduction. There was a strong view that technical costs

could be brought down, but a lot of the costs are also driven by relational factors – as in, the time it takes to bring stakeholders together and reach collective decisions. Impact bonds by their very nature bring together additional stakeholders when compared to other contracting models, and so it is unlikely the relational costs could be reduced to any significant degree. Indeed this was the experience in the Quality Education India (QEI) DIB, which built on the Educate Girls DIB. Whilst stakeholders felt the technical aspects of the impact bond design were achieved in a shorter timeframe because stakeholders were able to build on the templates / lessons from the Educate Girls DIB, as the DIB involved more stakeholders than the Educate Girls DIB, the stakeholder management time (and therefore relational aspects) actually increased.

Furthermore, there is a risk that, in a bid to drive down costs, critical elements of the impact bond design are removed, which could inhibit its benefits. In particular, impact bonds in the UK have tended to move away including rigorous estimates of the counterfactual in the outcome payment structure, some of this driven by the desire to reduce costs. However, it would seem logical that any contract commissioning for outcomes ensures those outcomes are captured in a

rigorous manner. In removing some costs you therefore also risk removing some of the value of impact bonds.

With these findings in mind, below we outline recommendations for all DIB stakeholders, and designers, on how transaction costs could be reduced for future impact bonds.

## Recommendations /

### Recommendations to all DIB stakeholders

- Make contracts, payment terms, feasibility studies, investor documents and learning documents publicly available.
- Building a database on interest rates, outcome metrics and rate cards and drawing on private sector expertise on pricing risk would facilitate the growing of the DIBs market.

### Recommendations to DIB designers in the DIBs market

- Clearly agree upfront the roles and responsibilities of all involved parties, including how these responsibilities may change depending on circumstances.
- Consider carefully the number and types of stakeholders involved, as, in this early stage of the market, complexities and potential inefficiencies increase with the number of stakeholders. Consider solutions to reducing this complexity, such as limiting the number of stakeholders involved or using contractual arrangements that simplify the processes required.
- Develop outcome metrics and rate cards that are understood by all stakeholders and linked to other metrics used in the sector or country, to increase the value of the learning generated, minimise the costs of data collection and facilitate the broader DIB market and / or potential transition to a social impact bond (SIB).
- Collaboration is important to reducing transaction costs. Seek to draw on the expertise and experience of stakeholders within the DIB.

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