Sattva Knowledge Institute SKI primer

# UNLOCKING INNOVATIVE FINANCE FOR LIVELIHOOD

Part A: An introduction to Innovative and Blended Financing

August 2022

# Acknowledgements

## About the Authors

The primer has been written by **Harsha Sanyukta**. She was supported by **Deshna Saraogi, Samar Sabarwal and Gargi Das.**

## Disclaimer



## About Sattva Knowledge Institute

Sattva Knowledge Institute (SKI), established in 2022, is our official knowledge platform at Sattva. The SKI platform aims to guide investment decisions for impact, shedding light on urgent problems and high potential solutions, so that stakeholders can build greater awareness and a bias towards concerted action. Our focus is on offering solutions over symptoms, carefully curating strong evidence-based research, and engaging decision-makers actively with our insights. Overall**, SKI aims to shift intent and action toward greater impact by influencing leaders with knowledge.** All of our content proactively leverages the capabilities, experience and proprietary data from across Sattva.

**Design:** Cognitive Designs; cognitive.designs@gmail.com

# CONTENTS

# EXECUTIVE SUMMARY

## Gaps in traditional financing and social impact funding.

It is estimated that there is currently **an annual shortfall of US $2.5 trillion in developing countries** with respect to funding Sustainable Development Goals (SDG). **In India, social impact funding falls short by forty-seven per cent,** demonstrating that traditional funding in the shape of public finance and philanthropic capital do not adequately bridge investment gaps. It has also been observed that traditional funding does not sufficiently leverage the incentivising of private investment, outcome-focused investment, and the efficient use of funds.

## Shifting to innovative financing.

Innovative financing has emerged to address these gaps in the traditional funding setup and catalyse additional funds for development assistance with a focus on outcome and innovation. There is a shift from the ‘grant only approach’ to diverse financial instruments and the supplementation of public and philanthropic funding with private investment. The spectrum of innovative financing includes newer models of grant and debt-based financing, conditional financing through development funds, and private investments such as impact investment and socially responsive investment focused on social as well as financial returns.

## The emergence of blended financing to harness private capital for increased impact.

A subcomponent of innovative shifting, Blended financing, allows a mix of innovative financing instruments across the spectrum and uses public and philanthropic grants to de-risk and incentivise private investment for development needs. Focused on the three principles of Leverage, Impact and Return, blended finance has mobilized US $166 billion in capital to date and is poised to be an effective tool to address funding gaps and maximise impact. It can particularly have an impact on livelihood since it has the potential to solve Small and Medium Enterprises’ (SME) access to capital, support women’s entrepreneurship, and improve access to skilling opportunities for large-scale workforces.

# INNOVATIVE FINANCING: OVERVIEW

# Introduction of the Sattva series on funding for livelihood.

## Introduction of the Two-Part Series on Innovative Financing

As the social funding gap deepens, there is a collective discourse developing on reimagining traditional modes of financing development solutions and harnessing private capital for development. Innovative and blended financing presents solutions to overcome some of the key intractable challenges in the livelihood ecosystem such as access to capital for SMEs and nano micro enterprises, support of women entrepreneurs, and skilling of low income youth, amongst others.

We have conducted a two-part study to demystify funding trends in livelihood and establish innovative financing instruments and models for livelihood:

- Part A  Innovative financing: an introduction
- Part B  Leveraging innovative financing for solving livelihood challenges

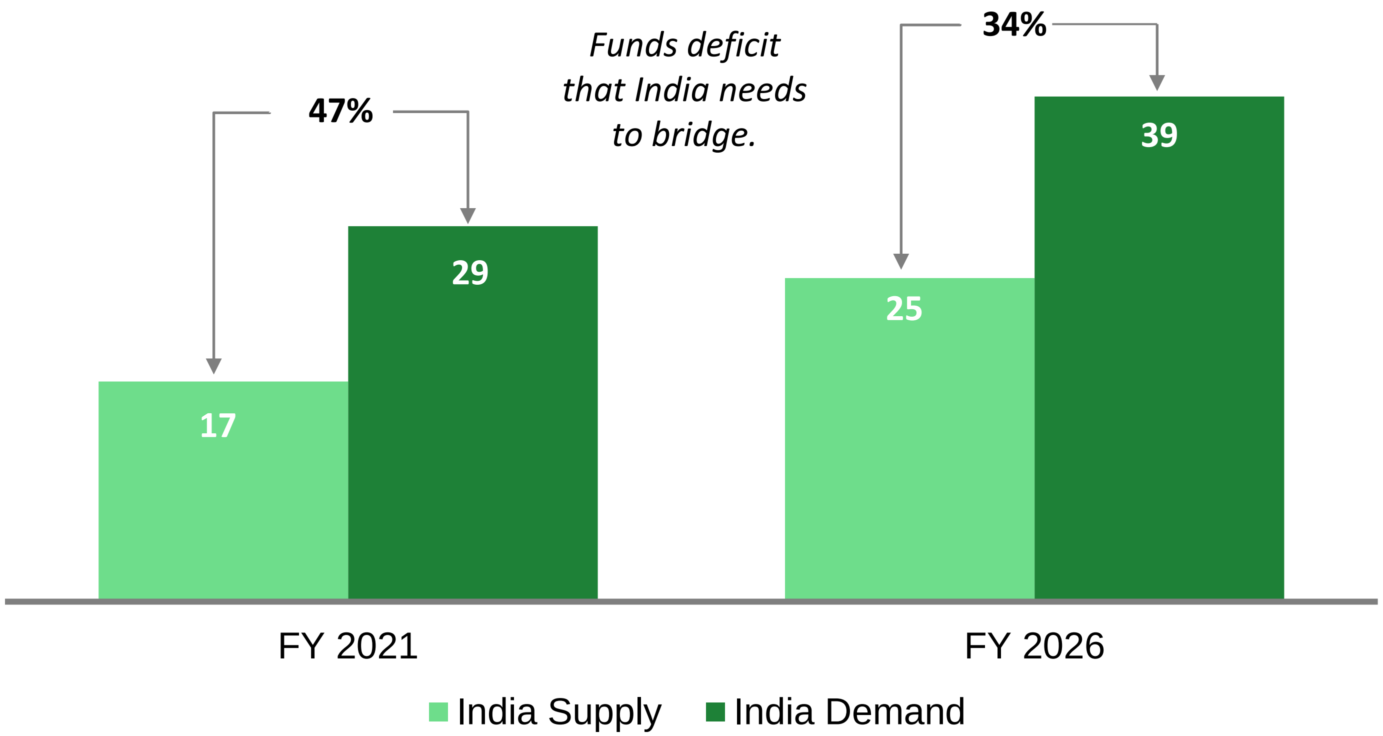
## Objective of the Primer on Innovative Financing

This study focuses on understanding **innovative financing mechanisms for solving development challenges.** It shows the key **shifting trends** in financing and **introduces blended financing,** while briefly looking into the potential it holds for livelihood.

# A significant gap exists in traditional social impact funding in India.

Traditional financing for development typically uses a **‘grant model’** by **public or philanthropic actors** where the actors are primarily seen as ‘project donors’ in the setup.

**India lens: demand and supply gap in social sector funding in USD trillions**
(Dasra, Bain & Company 2021)




- The UN estimates a current annual shortfall of US $2.5 trillion in developing countries which could impede their work on SDGs.
- A viable solution to this is philanthropic funding, which in India grew from approximately US $2 billion in 2010 to US $8.7 billion in 2018.
- However, it has been observed that public finance and philanthropic capital have proven inadequate in bridging investment gaps.

# The traditional financing mechanism also holds little incentive for the private sector and lacks an outcome-focused approach to solving development challenges.

## Key gaps in the traditional financing mechanism

**Lack of private funding based on perceived risks**

Limited funding by private funders and commercial and risk investors as expectations are hinged on financial returns and cost recovery.

**Uncertainty in alignment to expected outcomes**

Traditional funding is input driven and there is little accountability of the output or result leading to piecemeal impact.

**Limited scalability and effectiveness**

Lack of innovative, efficient and robust structures in the traditional grant setup leads to limited scalability of the models.

**Lack of objective measurement indicators**

Absence of data and a metric-oriented approach to measure success in the traditional funding setup hinders measurement.

# To address these gaps, there has been a shift toward innovative financing approaches in the development sector.

## What is innovating financing?

### OECD

Operational mechanisms that raise additional finance in support of international development that go beyond traditional spending, involving the transfer of resources to developing countries and the official sector(ILO 2018).

### World Bank

Non-traditional mechanisms that tap new sources or engage new partners, enhance the efficiency of financial flows, or make them more results-oriented (ILO 2018).

### Citi Foundation

Innovative approaches in mobilising resources and increasing the effectiveness and efficiency of financial flows that address developmental challenges (ILO 2018).

## The universe of innovative financing

Development Funding: Government and Philanthropy

Blended or Catalytic Funding

Private Funding: Investors and Private Capital

**Social Impact** ↔ **Financial Gain**

Shift from **'grant only approach'** to financial instruments based on diverse debt, equity and hybrid models.

Fund source **to include development aid and/or commercial capital**.

# The innovative financing spectrum includes a diverse set of financing instruments ranging from traditional assistance to commercial investment.

Adapted from USAID framework

**1. Development funding: government and philanthropy** | **3. Blended** | **2. Private funding: investors and private capital**

Social Impact ⟷ Financial Gain

| | Traditional grant-based funding | Innovative grant-based financing | Result-based conditional financing | Blended or catalytic finance | Impact investment | Responsible investment | Commercial or equity-based investment |
|---|---|---|---|---|---|---|---|
| Description | • Donor grants for direct project implementation. | • Evolved grants for long-term ecosystem strengthening, capacity building, vouchers etc. | • Funding is linked to the achievement of certain outcomes. | • Models that use public and philanthropic funds to catalyse private investment for development. | • Investment with an intent to have a measurable environmental and/or social return. | • Investment that enhances long-term value by using *ESG factors to mitigate risks and identify growth opportunities. | • Conventional investment with no or limited concessionary outlook or regard for social impact. |
| Instrument | • Grants for funding traditional projects. | • Capacity building funds.<br>• Operational funds. | • Pay for success models. | • First loss default guarantee, social success notes etc. | • Impact-first investment funds. | • ESG investment.<br>• Thematic investment. | • Loans at market rate.<br>• Equity investment. |
| | Social return only | Social return only | Social return only | Social return + cost recovery | Social return + cost recovery | Financial focus + social return | Financial return only |

**Mix of financial instruments: Blended or catalytic finance**

*Environmental, Social, and Governance (ESG)

# INNOVATIVE TRENDS IN PHILANTHROPY AND PUBLIC FUNDING

# 1A. Innovative grant-based models have emerged with a focus on capacity building, different scholarship models, as well as in-kind or non-cash models.

**Grant-based project funding**

The disproportionate focus on direct project implementation through grant mode (typically 70-90% of the funding), making it the common implementation model amongst funders leading to unsustainable solutions and piecemeal impact. (Sattva 2022)

**Innovative models of grant**

Grants are increasingly being used in innovative models for maximising sustainable impact and including last-mile beneficiaries.

## Different kinds of innovative models of grant (non exhaustive)

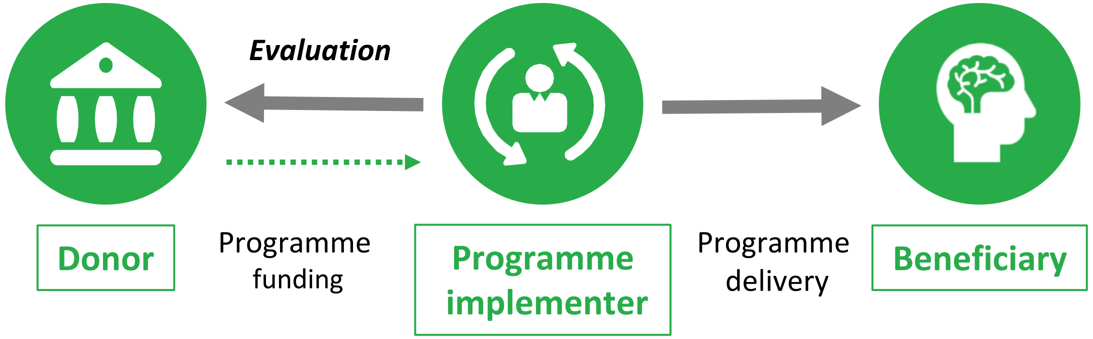
| Capacity building grants | Operating fund grants | Challenge or scholarship grants | In kind or non-cash grants |
|---|---|---|---|
| Grants are directed toward capacity and leadership building in non-profits or organisations to ensure systematic and long term changes. | Grants include provision for operating funds of the organisation and other add-on costs. | Funders provide grants based on selection parameters and in the form of challenges or scholarships. | Funders provide in-kind grant in lieu of or in addition to monetary donations, including vouchers to enable access to good and services. |

# 1B. Result-based financing aims to shift the focus from input to output with increased accountability toward results.

**Result-based financing**

**Result-based financing** focuses on **tying funds to specific outcomes** rather than paying for inputs, allowing greater implementer accountability and efficient allocation of donor funds to proven programmes.

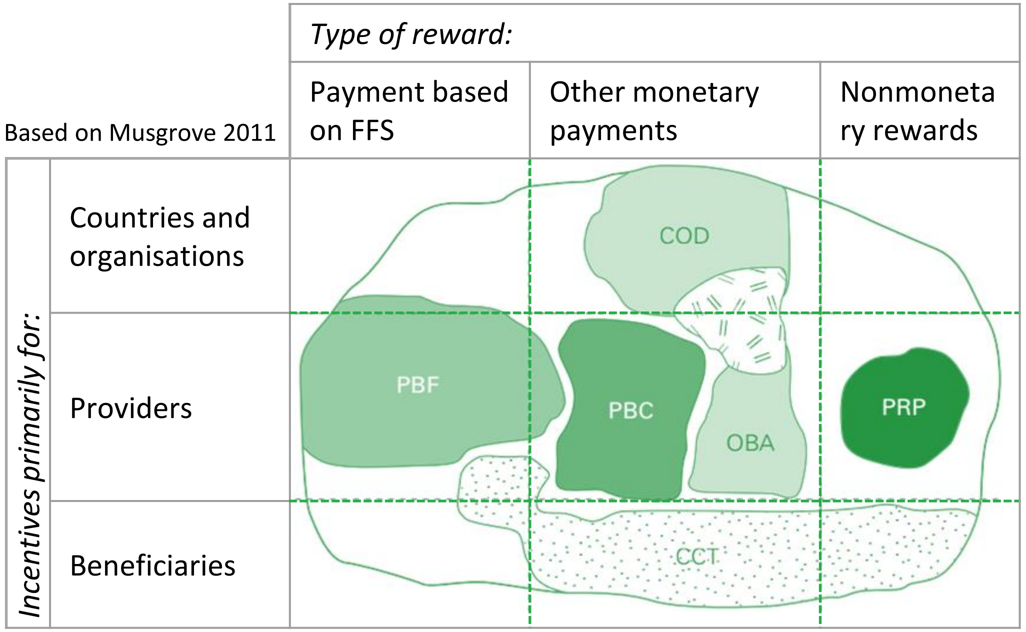
It is also called **"Pay for Performance" (P4P), "Output-based financing,"** or **"Performance-based Financing (PBF).**




## Advantages of this model:

- RBF instruments can financially incentivise an implementer to work harder and/or focus resources on those activities that maximise impact.
- RBF instruments can shift risk away from donors and onto the implementer by only paying for activities that have an impact.

## Structure of result-based financing:




*Note:* CCT = conditional cash transfer; COD = cash on delivery; FFS = fee-for-service; OBA = output-based aid; PBC = performance-based contracting; PBF = performance-based financing; PRP = Provider Recognition Programme


# INNOVATIVE TRENDS IN PRIVATE INVESTMENT FOR DEVELOPMENT

# 2A. Impact investing includes models based on debt and equity that aim at both social impact and financial return.

## Impact Investments

**Impact investments** are investments made with the intention to generate positive, measurable social and environmental impact alongside financial returns.

### Core tenets of impact investing (GINN 2020)

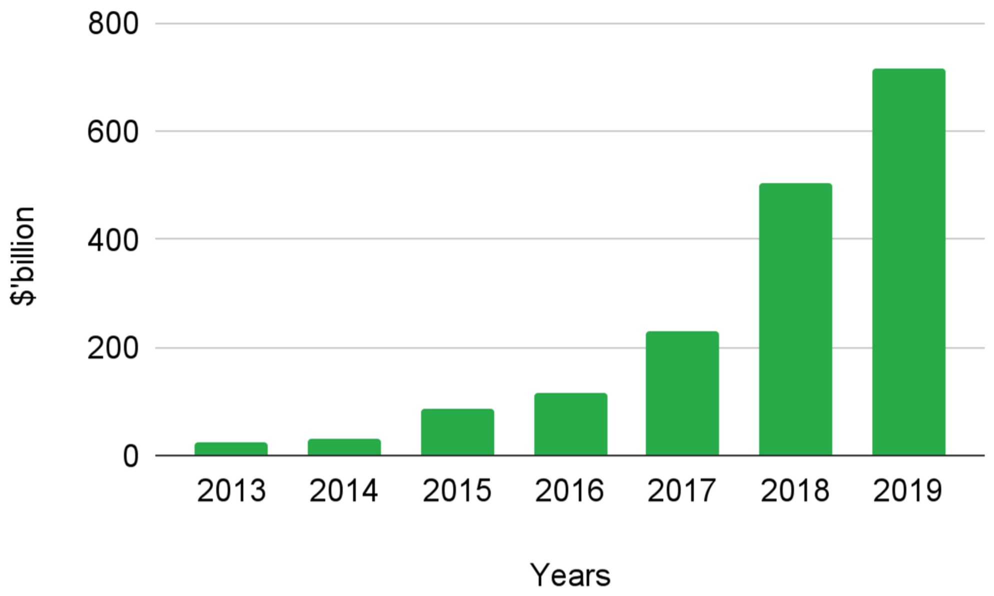
01 An investor's intention to have a positive social or environmental impact through investments is essential to impact investing.

02 Impact investments are expected to generate a financial return on capital or, at minimum, a return on capital.

03 Impact investment targets financial returns that range from concessionary instruments to risk-adjusted market rates, and can be made across asset classes like cash equivalents, fixed income, venture capital and private equity.

04 Commitment to measure and report the social and environmental performance and progress of underlying investments ensures transparency

**The impact investing market has grown from US $25 Billion in 2013 to US $715 billion in 2019 (GINN Annual Survey 2013-2020)**



# 2B. Responsible investing, including ESG and SRI Investing, is aimed at socially conscious investment and is gaining momentum globally.

**Responsible Investing**

**Responsible investing,** also known as social investment, is an investment that is considered socially responsible due to the nature of the business the company conducts. A common theme for socially responsible investments is socially conscious investing (Chen 2022).

**50%**

ESG-mandated assets are projected to make up half of all professionally managed assets globally by 2024 (Taylor 2022).

**2.5X**

Assets under management for ESG funds increased **2.5 times**, between FY 2020 to FY 2021, **to US $650 million** in India (Press Trust of India 2022).

**Metrics for screening investment**

**Environment**

- Company's carbon footprint
- Sustainability efforts
- Air and water pollution
- Energy efficiency
- Waste management

**Social**

- Racial and gender diversity
- Data protection and privacy
- Human rights
- Labour standards
- Employee and customer Satisfaction

**Governance**

- Board composition
- Bribery & corruption
- Executive compensation
- Lobbying
- Political contributions

*Illustrative

# THE EMERGENCE OF BLENDED FINANCE STRUCTURES

# The innovative financing spectrum includes a diverse set of financing instruments ranging from traditional assistance to commercial investment.

Adapted from USAID framework

1. Development funding: government and philanthropy | 3. Blended | 2. Private funding: investors and private capital

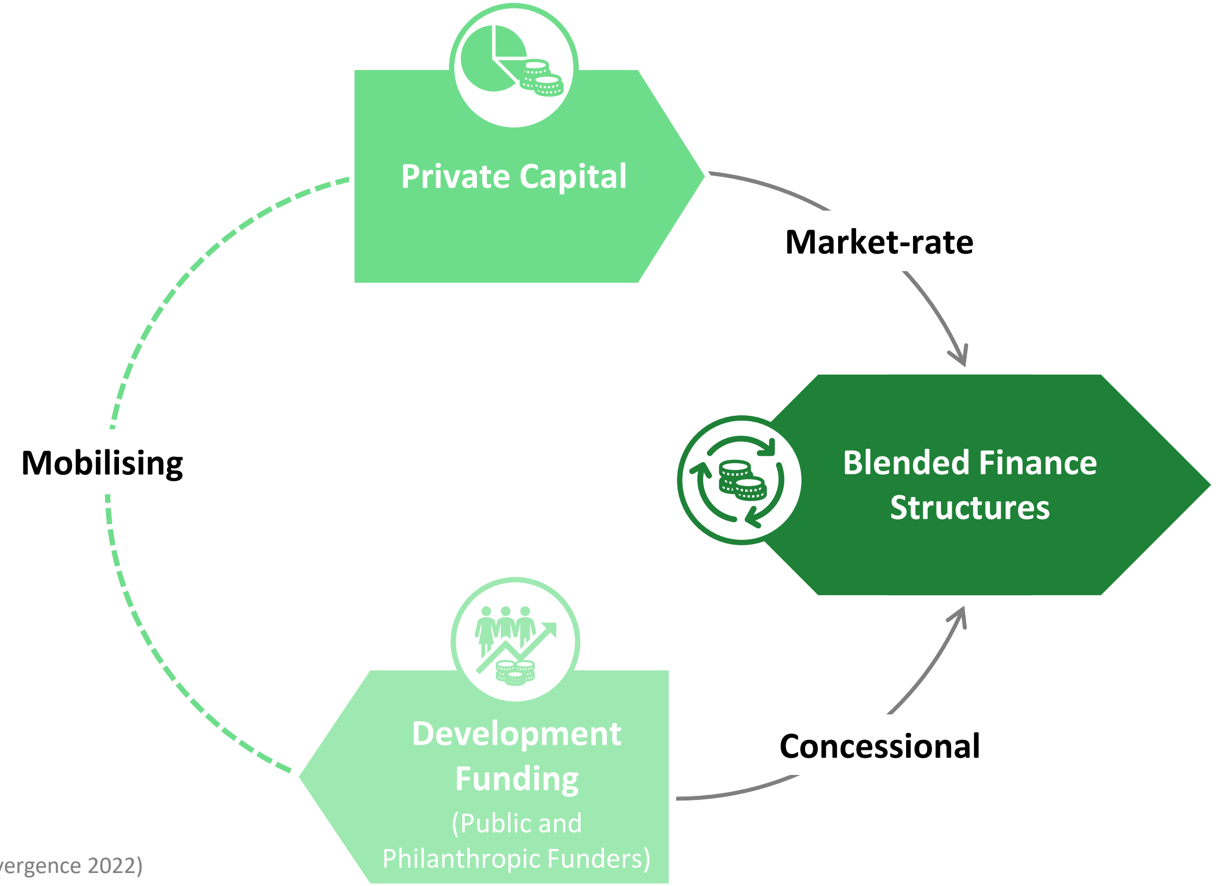
Social Impact ⟷ Financial Gain

| | Traditional grant-based funding | Innovative grant-based financing | Result-based conditional financing | Blended or catalytic finance | Impact investment | Responsible investment | Commercial or equity-based investment |
|---|---|---|---|---|---|---|---|
| Description | • Donor grants for direct project implementation. | • Evolved grants for long-term ecosystem strengthening, capacity building, vouchers etc. | • Funding is linked to the achievement of certain outcomes. | • Models that use public and philanthropic funds to catalyse private investment for development. | • Investment with an intent to have a measurable environmental and/or social return. | • Investment that enhances long-term value by using *ESG factors to mitigate risks and identify growth opportunities. | • Conventional investment with no or limited concessionary outlook or regard for social impact. |
| Instrument | • Grants for funding traditional projects. | • Capacity building funds.<br>• Operational funds. | • Pay for success models. | • First loss default guarantee, social success notes etc. | • Impact-first investment funds. | • ESG investment.<br>• Thematic investment. | • Loans at market rate.<br>• Equity investment. |
| | Social return only | Social return only | Social return only | Social return + cost recovery | Social return + cost recovery | Financial focus + social return | Financial return only |

Mix of financial instruments: Blended or catalytic finance

# The mixing of private capital and development funding by transactions across the innovative financing spectrum have led to the emergence of blended finance.

Blended finance makes use of existing financial instruments and types of capital such as grants, guarantees, debt, and equity and uses them in creative ways to de-risk and thus incentivise private investment.




(Convergence 2022)

Blended finance **addresses key investment barriers** for private investors such as:

(i) high perceived and real risk and

(ii) poor returns for the risk relative to comparable investments.

Blended finance has **three main characteristics**:

1. **Leverage:** Development and philanthropic funds are used to catalyse private investment.
2. **Impact:** Investments must result in social, economic, and environmental progress.
3. **Returns:** Financial returns must be in line with private investor expectations.

# Blended finance manages to address the gaps in the traditional financing model by bringing diverse financing instruments and private actors into the ecosystem.

## Benefits of blended finance

### De-risks Investments

In contrast to traditional grant funding which deploys funds upfront, blended finance programmes are outcome-based and thus ensure maximisation of social return by de-risking investments.

### Mobilises capital for development

Blended finance instruments either recycle capital or unlock further private or commercial capital which enables a multiplier effect in scaling social impact.

### Enables Collaboration

Facilitates effective collaboration with different stakeholders in the ecosystem and brings in both funding and expertise from different players.

### Fosters Transparency

Blended financing allows for transparency since it is based on data or evidence-based monitoring and outcome measurement.

# Globally, blended finance has mobilised approximately US $166 billion in capital to date towards sustainable development in developing countries.

## Measuring private sector investment in sustainable development

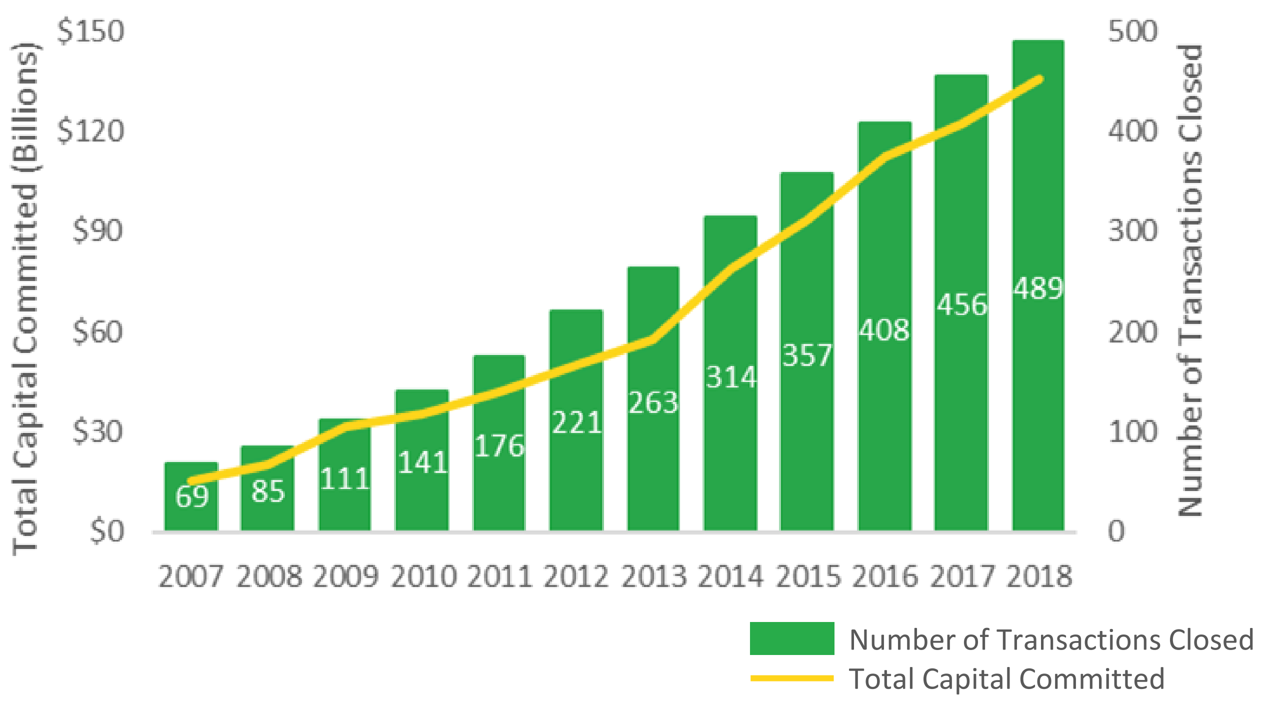



Figure: Overall blended finance market 2010-2020 (Convergence 2021)

## Size of the innovative financing ecosystem

- Blended finance has **mobilised approximately US $166 billion** in capital to date towards sustainable development in developing countries (Convergence 2021).
- **Increasing pressure from governments, investors, and citizens** to produce tangible environmental and social results and to achieve SDGs will further increase the market size.
- **India is the second top target country for blended finance transactions** and receives 12% of the total transactions (Convergence 2021).

# Blended finance works in some common structures using a mixed model of debt, equity, guarantee and hybrid models to de-risk private investment.

Public or philanthropic investors (Convergence 2022) provide funds (debt or equity) on below-market terms within the capital structure to lower the overall costs of capital or to provide an additional layer of protection to private investors.

| Equity | Debt and/or equity | Dect and/or equity |
|---|---|---|
| **Junior equity** | **Subordinate debt** | **First-loss capital** |

Public or philanthropic investors provide risk sharing mechanisms through first loss and second loss mechanisms.

Public or philanthropic investors provide credit enhancement through guarantees or insurance on below-market terms.

| Debt and/or equity | Guarantee |
|---|---|

| Debt and/or equity | Technical assistance |
|---|---|

Transaction design or preparation is grant-funded (including project preparation and design stage grants). Grant-funded technical assistance facilities can be utilised pre or post-investment to strengthen commercial viability and development impact.

(Convergence 2022)

# Social or Development Impact Bond.

A Social or Development Impact Bond is a pay-for-results funding model involving multiple parties. It is a form of result-based financing where an investor provides upfront capital for social services programmes which is to be repaid based on the programme's achievement of predetermined outcomes. SIBs and DIBs are essentially the same; however, in DIB, the funder is the government.

## Advantages of this model:

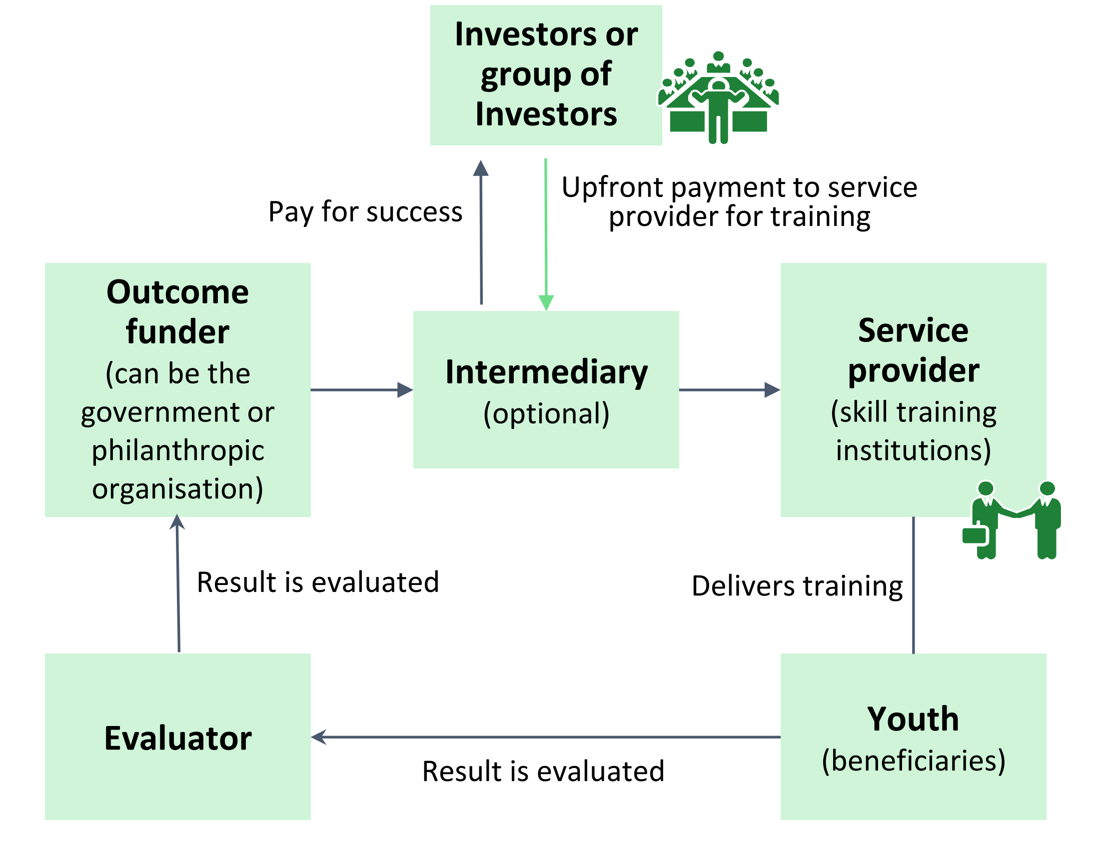
- Encourages innovation and tackles difficult social problems.
- Funder only has to pay for results and third-party investor bears all the risks.
- Accelerates the rate of learning about the feasibility of approaches i.e. which ones work and which do not.
- Enables collaboration between multiple stakeholders (Briddhi 2020).

## What's innovative?

| Increased resources for funding | Increased efficiency of capital flow | Improved outcome of the funding |
|---|---|---|
| | | |

Yes

no/ low impact




(Briddhi 2021)

There are bonds that have cost under USD 1 million, and others that cost USD 8-10 million. https://idronline.org/idr-explains-development-impact-bonds/

# Returnable grants or revolving fund.

Grants given at zero or low interest to the beneficiary is returned and recycled to grant aid for scale-up of operations or revolved to another beneficiary. The funding is chosen to be a grant or a debt based on the repayment ability of the borrower or beneficiary.

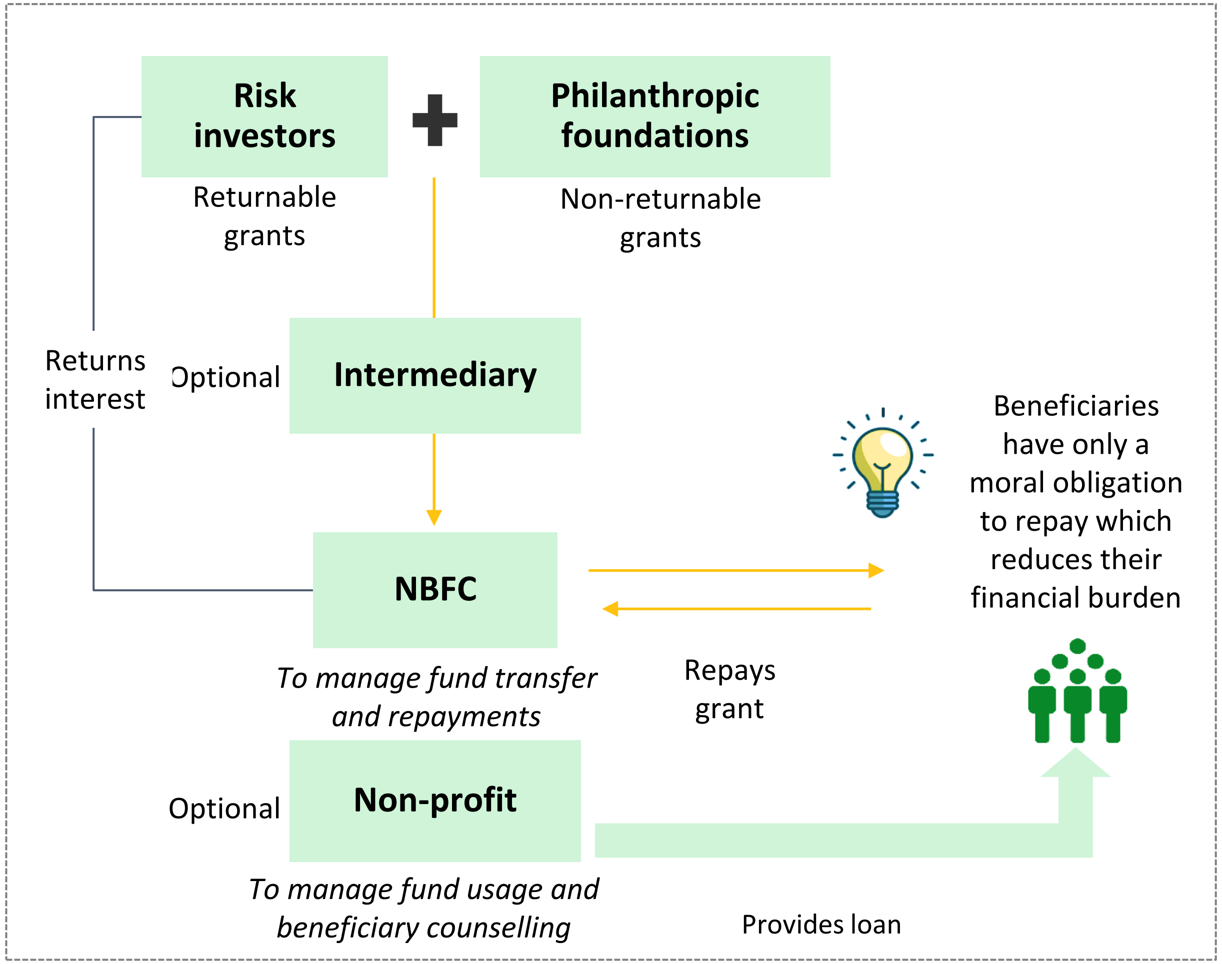
## Advantages of this model:

- Impact maximisation where the same grant money can benefit more than one person.
- Low complexity leading to ease in implementation.
- Shorter go-to-market timeframe.

## What's innovative?

| Increased resources for funding | Increased efficiency of capital flow | Improved outcome of the funding |
|---|---|---|
| | | |

Yes no/ low impact



# Catalytic first-loss guarantee.

The first-loss guarantee is a mechanism whereby a third party compensates lenders if the borrower defaults.

## Advantages of this model:

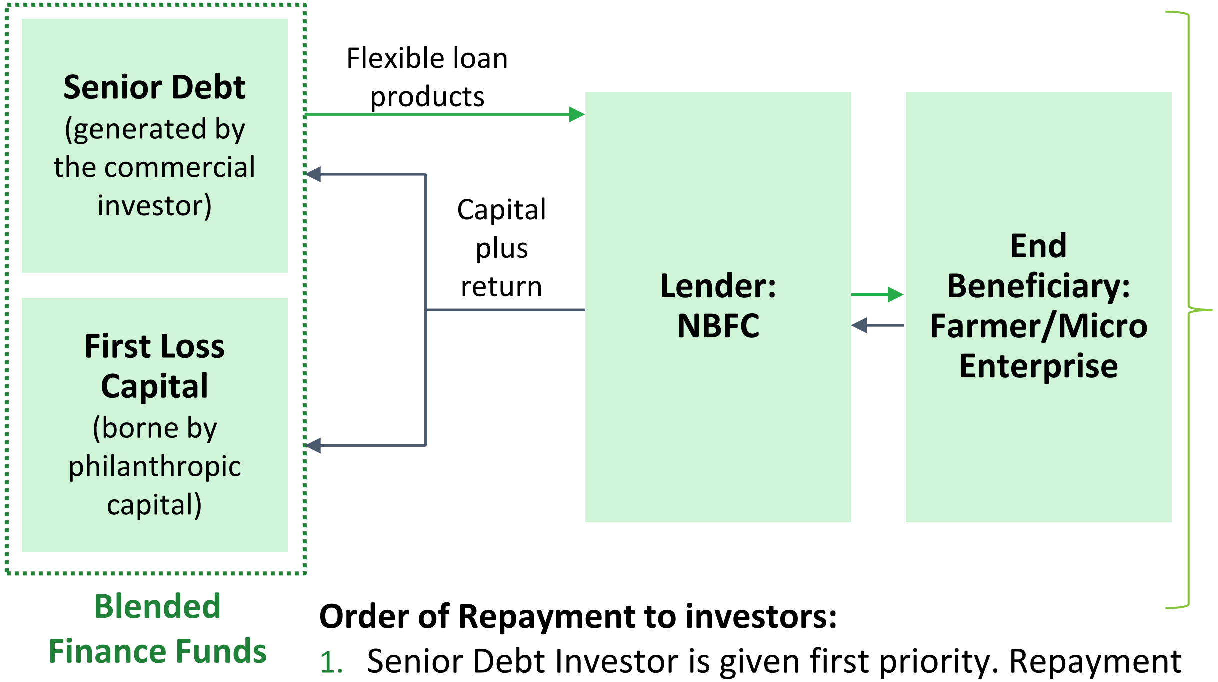
- Risk is absorbed by the grant or philanthropic capital under ‘first loss capital’.
- De-risking by grant or philanthropic capital draws in commercial capital providers.
- Lenders or Non-Banking Financial Companies (NBFCs) get access to flexible loans at lower costs.

## What’s innovative?

| Increased resources for funding | Increased efficiency of capital flow | Improved outcome of the funding |
|---|---|---|
| Yes | Yes | no/ low impact |

Yes   no/ low impact

## Blended Finance Solutions




**Order of Repayment to investors:**

1. Senior Debt Investor is given first priority. Repayment is first made to the Senior Debt provider in full.
2. Losses due to default (if any) are absorbed by the ‘first loss capital’ provider.

# Interest subvention and concession loans

Philanthropic donors pay interest on behalf of borrowers when there is timely repayment of debt which encourages borrowers to repay on time and builds their credit history.

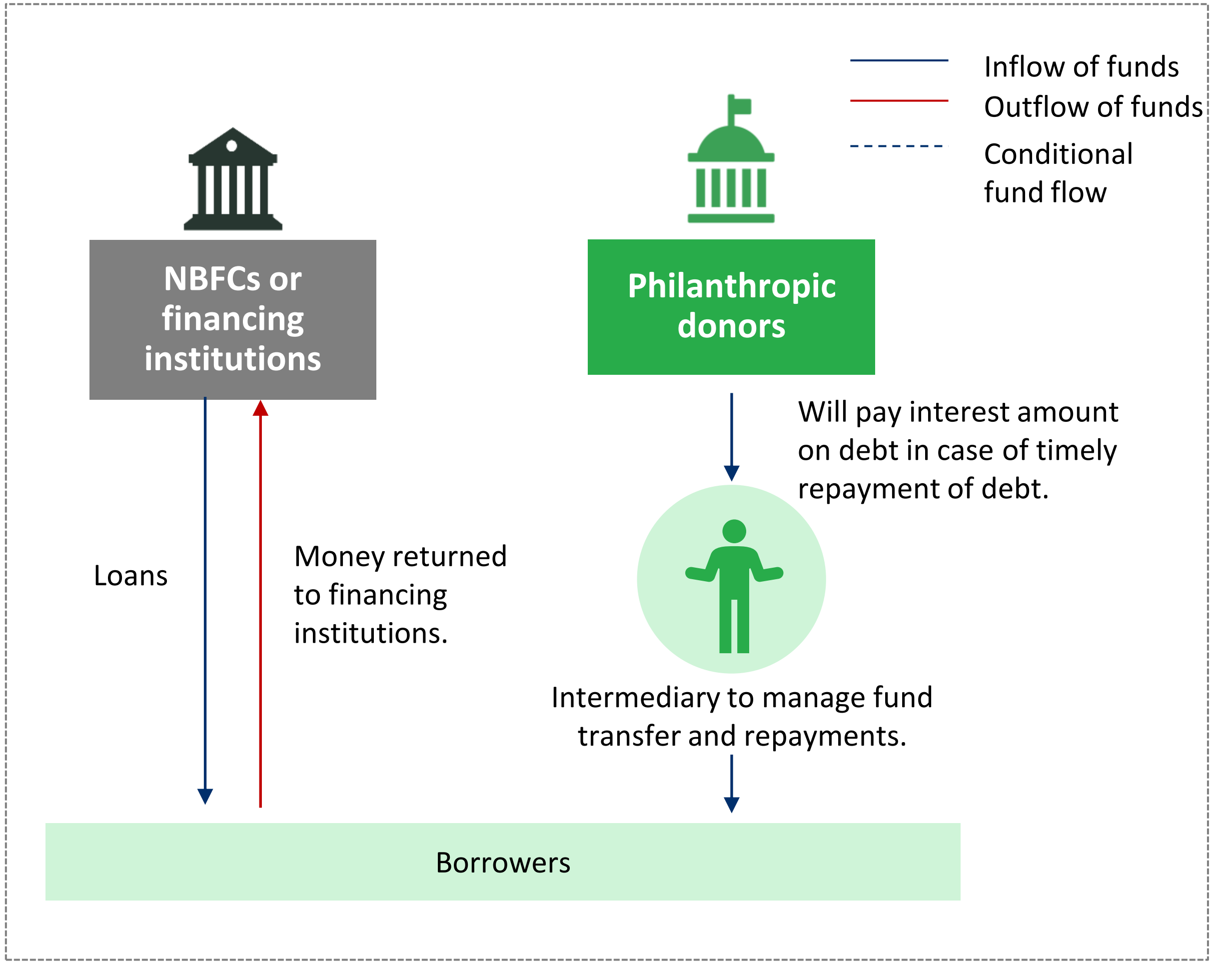
## Advantages of this model:

- Builds credit worthiness of the borrowers.
- Unlocks capital from NBFCs as philanthropic capital can be routed to meet the repayment.
- Enforces positive repayment behaviour amongst the borrowers.

## What's innovative?

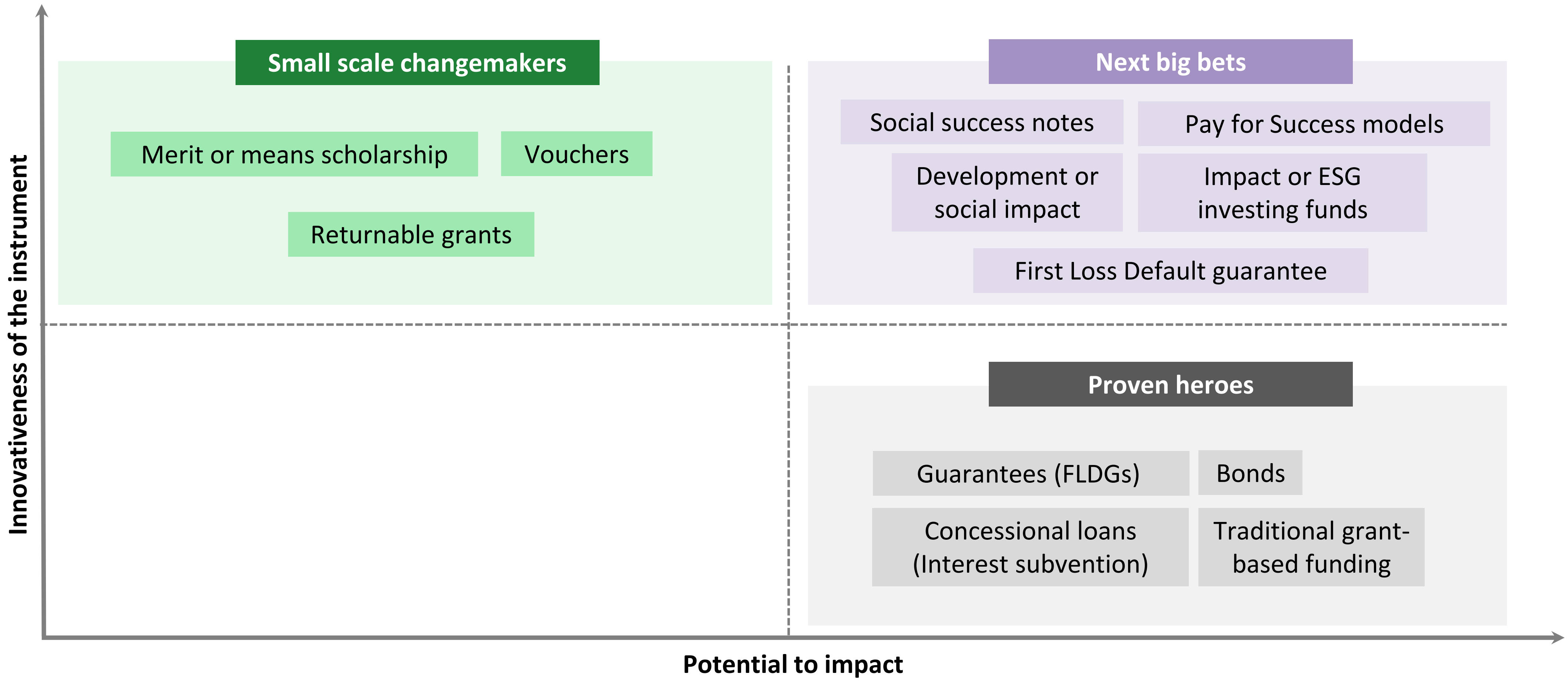
| Increased resources for funding | Increased efficiency of capital flow | Improved outcome of the funding |
|---|---|---|
| Yes | Yes | no/ low impact |

Yes | no/ low impact



# IMPLEMENTING INNOVATIVE FINANCING INSTRUMENTS FOR LIVELIHOOD

# These financing instruments demonstrate varying levels of innovation and potential impact with Social Impact Bonds, Impact Investing and Catalytic first-loss capital as the next big bets.



# Innovative finance can address key gaps in livelihood around access to finance for SMEs, and support women entrepreneurs and large scale skilling opportunities for youth.

## Key funding gaps in the livelihood ecosystem

- **Micro and nano entrepreneurs lack the capital** for operations, equipment, capacity development, and market linkages.
- **Credit gap of USD $565 billion** inhibits MSME growth (IFC 2018).
- **COVID has impacted** the livelihood of the self-employed workforce.

- **Less than six per cent** of the workforce is formally trained (NITI Aayog, 2020).
- Current **training models do not focus on placement and retention,** leading to unsustainable impact.
- **Training is not aimed at aspirational roles** and does not align with market needs.

**Innovation financing to resolve livelihood gaps**

## Opportunities

- **Mobilising private sector institutions** to lend to informal sector workers using blended finance mechanisms.
- **Building the credit history** of MSMEs and informal sector workers.
- Opportunity to **address the needs of women-owned enterprises.**

- **Financing low-income youth** for short-term vocational training.
- Ensuring **placement-led training and sustainable employment.**
- **Financing merit students' long-term aspirational roles** for premium income and career progression.

# REFERENCES

1. Aspen Network of Development Entrepreneurs 2020, *Asha Impact- Social Success Note Playbook*, prepared by AVPN, India.
2. *Blended Finance | Convergence* 2022, viewed 16 August 2022.
3. Briddhi 2020, '*Innovative Finance Toolkit*' prepared by Briddhi, Bangladesh.
4. CFA Institute n.d, '*ESG Investing and Analysis*' viewed 26 August 2022.
5. Chen 2022, '*Socially Responsible Investment (SRI)*', *Investopedia*, updated 10 August 2022, viewed 26 August 2022.
6. Citi Foundation 2014, *Innovative Financing for Development: Scalable Business Models that Produce Economic, Social, and Environmental Outcomes*, prepared by Citi Foundation, Dalberg.
7. Dasra, Bain & Company 2021, *India Philanthropy Report 2021- Accelerating family philanthropy towards a thriving India*, prepared by Dasra, India.
8. GIIN 2020, *Annual Impact Investor Survey 2020*, prepared by GIIN, New York.
9. GIIN 2022, *What You Need to Know about Impact Investing*, viewed 16th August 2022.
10. International Finance Corporation 2018, *'Financing India's MSMEs- Estimation of Debt Requirement of MSMEs in India'*, prepared by IFC, Intellecap.
11. ILO 2018, *Innovative Finance: Putting your money to (decent) work*, prepared by ILO, Geneva.
12. Livemint 2021, '*ESG investing gains momentum globally, US leads with highest share of SRI assets*', *Livemint*, updated 21 July 2021, viewed 29 August 2022.
13. Napoletano, E. 2022, 'Environmental, Social And Governance: What Is ESG Investing?', *Forbes Advisor*, 24 February 2022, viewed 16 August 2022.
14. OECD n.d. *Blended Finance - OECD*, viewed 16 August 2022.
15. Organisation for Economic Co-operation and Development 2020, *ESG Investing: Practices, Progress and Challenges*, prepared by OECD, Paris.
16. Press Trust of India 2022, '*Assets under management for ESG funds up 2.5 times in FY21: Nasscom*', *Business Standard*, 29 January 2022, viewed on 26 August 2022
17. Saijel Kishan 2022, '*ESG by the Numbers: Sustainable Investing Set Records in 2021*', *Bloomberg*, 3 February 2022, viewed 16 August 2022.
18. Sattva Consulting 2022, '*Preparatory Note on Business Responsibility and Sustainability Reporting (BRSR)*' prepared by Sattva Consulting, Delhi.
19. Taylor 2022, '*ESG investing and sustainability*', *Deloitte Insights*, 5 April 2022, viewed 26 August 2022.
20. Tideline 2019, *Catalytic Capital Unlocking More Investment and Impact*, prepared by Tideline, New York.
21. U.S. Agency for International Development 2017, *Investing for Impact*, USAID, Washington, DC.
22. NITI Aayog 2020, Strategy for New India@75, prepared by NITI Aayog, Delhi