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IMPACT BONDS IN MEXICO: OPPORTUNITIES AND CHALLENGES

EXECUTIVE SUMMARY



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The authors would like to thank Zachary Levey from the Multilateral Investment Fund (MIF) and Miléna Castellnou from Instiglio for their support and feedback during the creation of this report, as well as all the organizations that contributed their time and valuable insight. We would also like to thank Fernanda Guerrero, Oscar Alva, Mariana Grajales, and Cecilia Galván for their support in the formatting and revision of this report.

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First edition: June 2017

Printed in Mexico

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IMPACT BONDS

OPPORTUNITIES AND CHALLENGES



Innovative
financing
model



Evidence-based
public policies



Public-private
collaboration

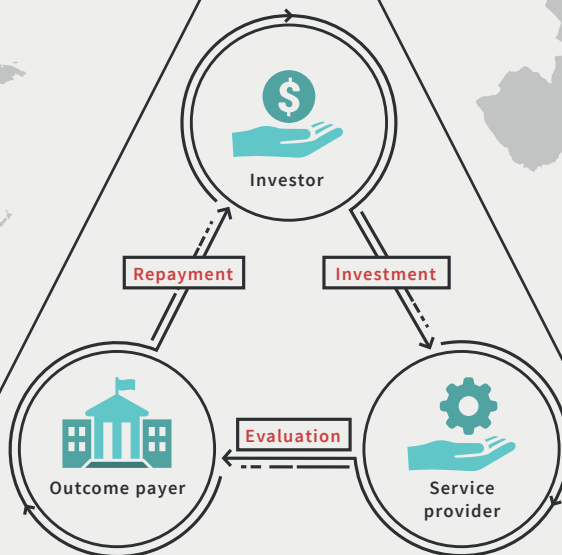


Focus on
results

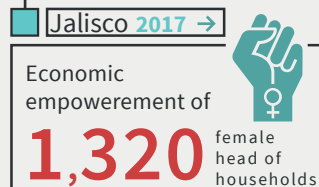
IMPACT BONDS AROUND THE WORLD

81*

- 36 EMPLOYMENT
- 24 SOCIAL WELFARE
- 7 EDUCATION
- 6 CRIMINAL JUSTICE
- 6 HEALTH
- 1 ENVIRONMENT
- 1 AGRICULTURE



MEXICAN EXPERIENCE



EXAMPLES OF POTENTIAL SECTORS IN MEXICO



Employment



Environment



Poverty
Alleviation



Child
welfare



Access to
education



Criminal
justice



Health

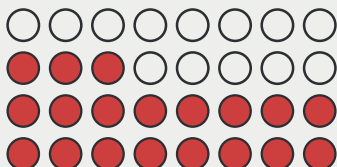


Agriculture

LEGAL AND POLITICAL CONTEXT IN MEXICO

19*

states in their ideal
political cycle



Legal Framework

PPPs

Law of Public-Private Partnerships

GREATEST STRENGTHS FOR AN IMPACT BOND

- + payment preference
- + investor certainty

INTRODUCTION

The persistence and enormity of today's economic and social development challenges require modern and innovative solutions that ensure better outcomes. Seven years ago, in an attempt to address these issues, the first impact bond was implemented in the United Kingdom with the goal of lowering recidivism rates. In the years since, governments around the world have focused on researching, studying, designing, and implementing impact bonds to improve social programs and address a variety of issues.

Mexico faces significant economic and social development challenges. In an increasingly complicated global environment, it is even more important to establish new and innovative partnerships to address these issues. *Impact Bonds in Mexico: Opportunities and Challenges* presents an overview of how the Mexican government can use this innovative tool to discover new ways to address the serious health, education, employment, and safety issues that the country faces. To address these challenges, a comprehensive and focused analysis is needed to support the creation of concrete, efficient, and effective public policies that involve diverse actors from the public and private sectors, as well as civil society.

An impact bond is an innovative and results-based tool that combines the experience and know-how of public, private, and civil society actors to create high-impact social, economic, and/or environmental programs and projects. This report presents an overview of international experience in the design, implementation, and evaluation of impact bonds; demystifies some of the most common questions about the structure; and clarifies the minimum criteria that must exist for them to be implemented. Additionally, the report provides an overview of the first impact bond in Mexico, as well as an analysis of the key factors that might impact the future successful implementation of impact bonds

in the country, including the relevant legal, political, financial, and investment context.

This report is a preliminary analysis of the potential of impact bonds in Mexico. It is not intended for use as a feasibility study for their direct implementation in any particular sector. We hope that *Impact Bonds in Mexico: Opportunities and Challenges* will help spark debate on both the national and local level among civil society, philanthropic, and public and private sector actors regarding the development of innovative, results-based, and data-driven public policy tools.

This report is divided into four sections:

The first section, titled 'Investing for the Future: What are Impact Bonds?,' provides a history and overview of the structure of impact bonds, focusing on their implementation in different parts of the world. This section also includes a review of the published academic research analyzing the potential and limitations of impact bonds.

The second section, titled 'Key Challenges for the Development of Mexico,' is focused on the underlying economic, social, and environmental challenges that might be addressed using an impact bond structure.

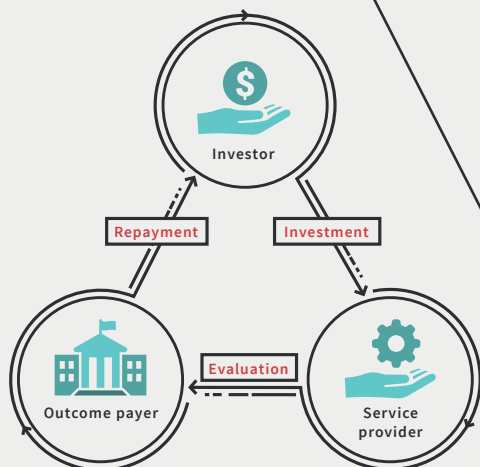
The third section, titled 'The Mexican Experience with Results-Based Financing,' is focused on the use of impact bonds in Mexico, including an analysis of results-based financing projects in the states of Jalisco and Chiapas.

The fourth and final section, titled 'The Environment for Impact Bonds in Mexico,' identifies and analyzes the current key legal, political, and financial considerations necessary to create a more conducive environment for impact bonds in Mexico.

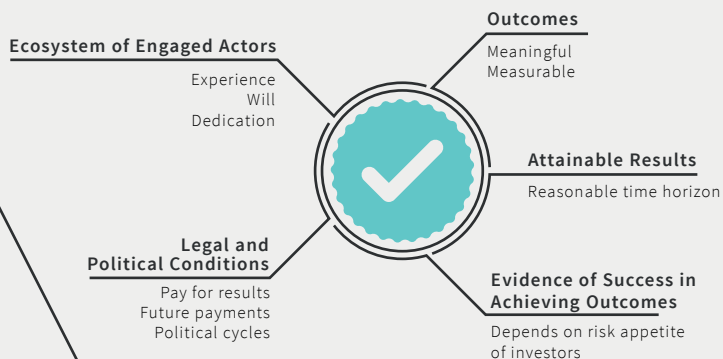
INVESTING FOR THE FUTURE

WHAT ARE IMPACT BONDS?

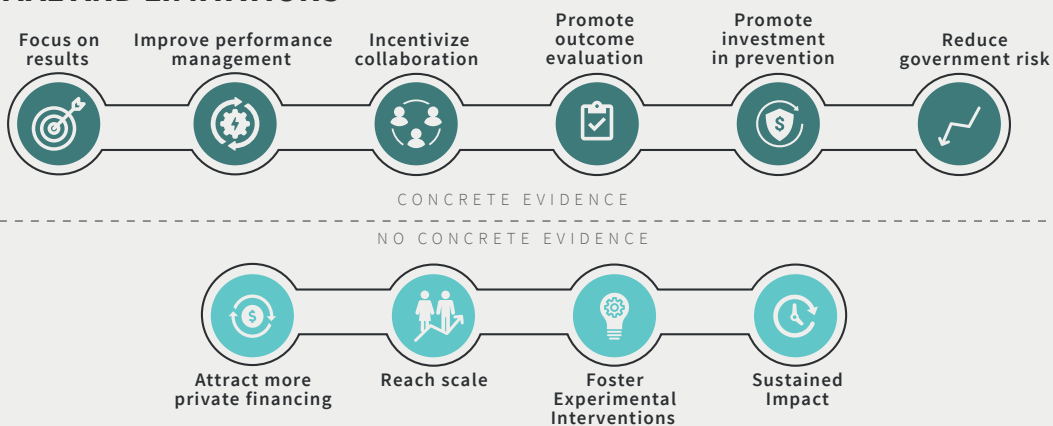
STRUCTURE



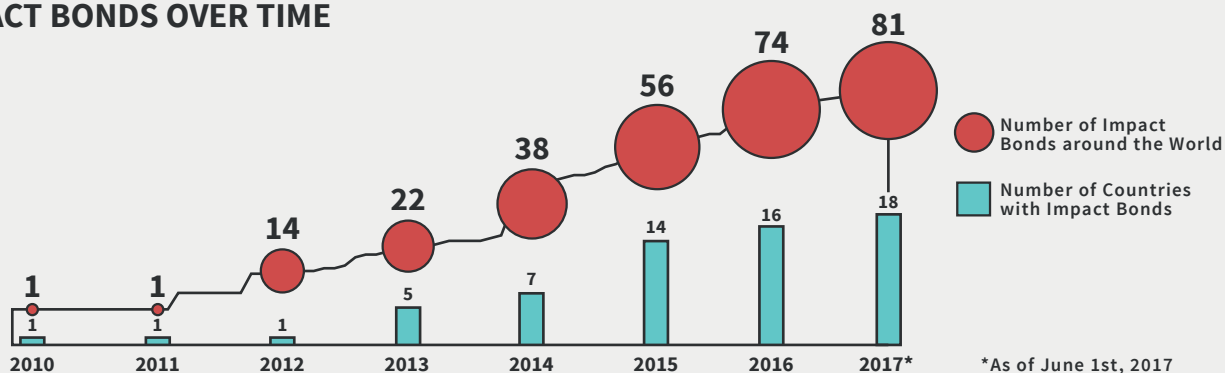
BASIC CRITERIA



POTENTIAL AND LIMITATIONS



IMPACT BONDS OVER TIME



1. INVESTING FOR THE FUTURE

WHAT ARE IMPACT BONDS?

Interest in impact bonds has increased over the past few years. The impact bond, a financial mechanism that harnesses private capital for social services and encourages the successful achievement of outcomes by making repayment contingent upon success, has been proposed as one way to address some of today's most pressing social and economic challenges.

Chapter 1 covers the transactional model of impact bonds, which generally involves three key stakeholders in addition to the target population: the investors, the outcome payer — generally a government, foundation, or international development agency—, and the service provider.

Impact Bonds are the result of the emergence of three global trends for the provision of social services. The first of these trends is an emphasis on data-driven interventions and a push for governments to implement more cost-effective programs; the second is a focus on increasing the value for money of these programs by providing financing based on results; and the third trend is an increasing interest from foundations and investors to achieve both social and financial returns.

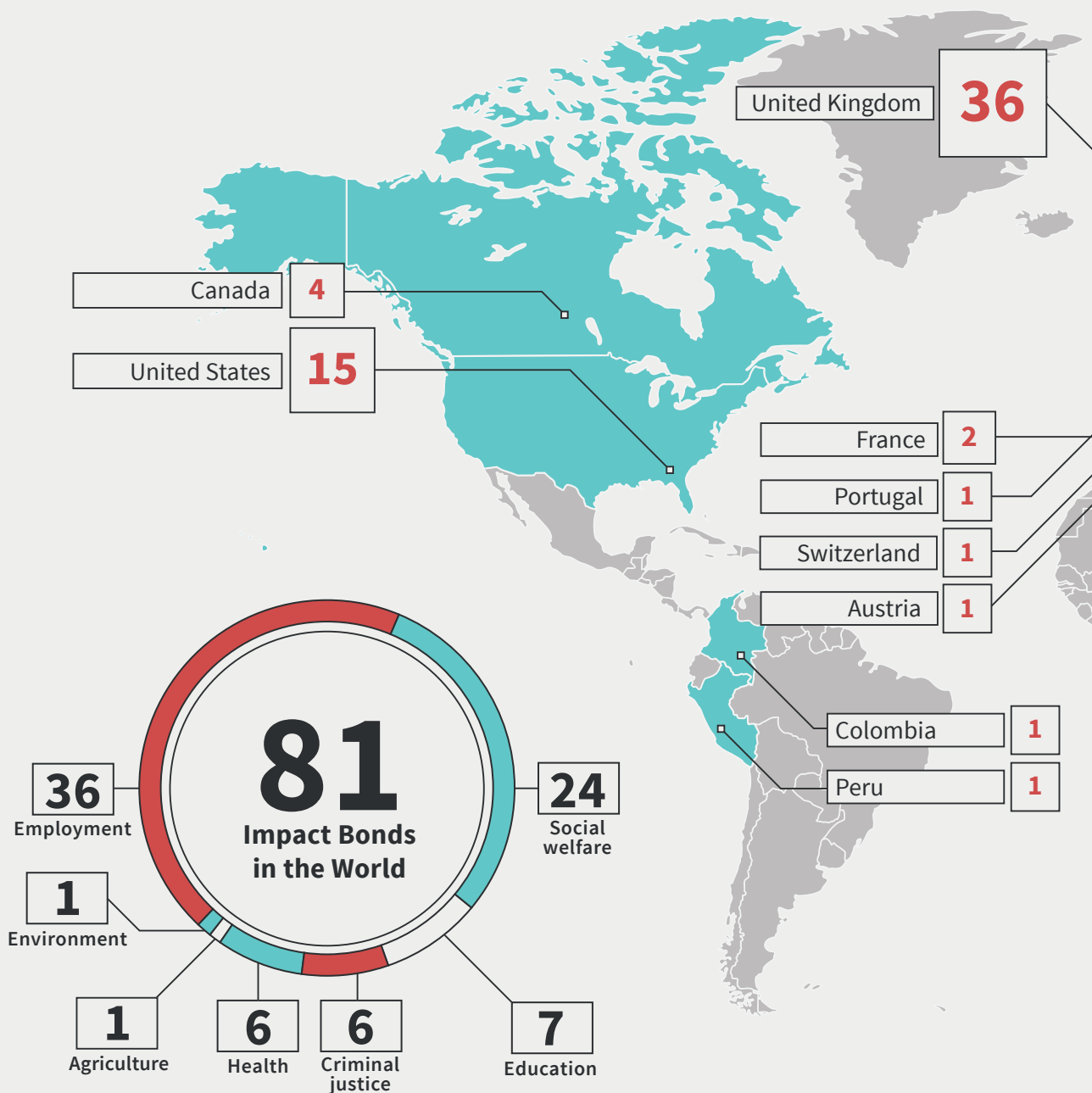
Impact Bonds have primarily been used to address gaps, including a lack of understanding of the most effective intervention model, insufficient political will, a lack of initial funding for a program that could generate future savings, or low capacity on the part of the government or service provider.

As of June 2017, 81 Impact Bonds had been implemented in Europe, the Americas, Asia, and Oceania. The Impact Bonds implemented to date have addressed different issues, including education, early childhood development, recidivism rates, and health, among others. The first impact bond was implemented in the United Kingdom in 2010 in an attempt to reduce recidivism. Since then, two Impact Bonds have been implemented in Latin America, with the most recent implemented in Colombia to provide skills training and employment support to vulnerable, unemployed individuals.

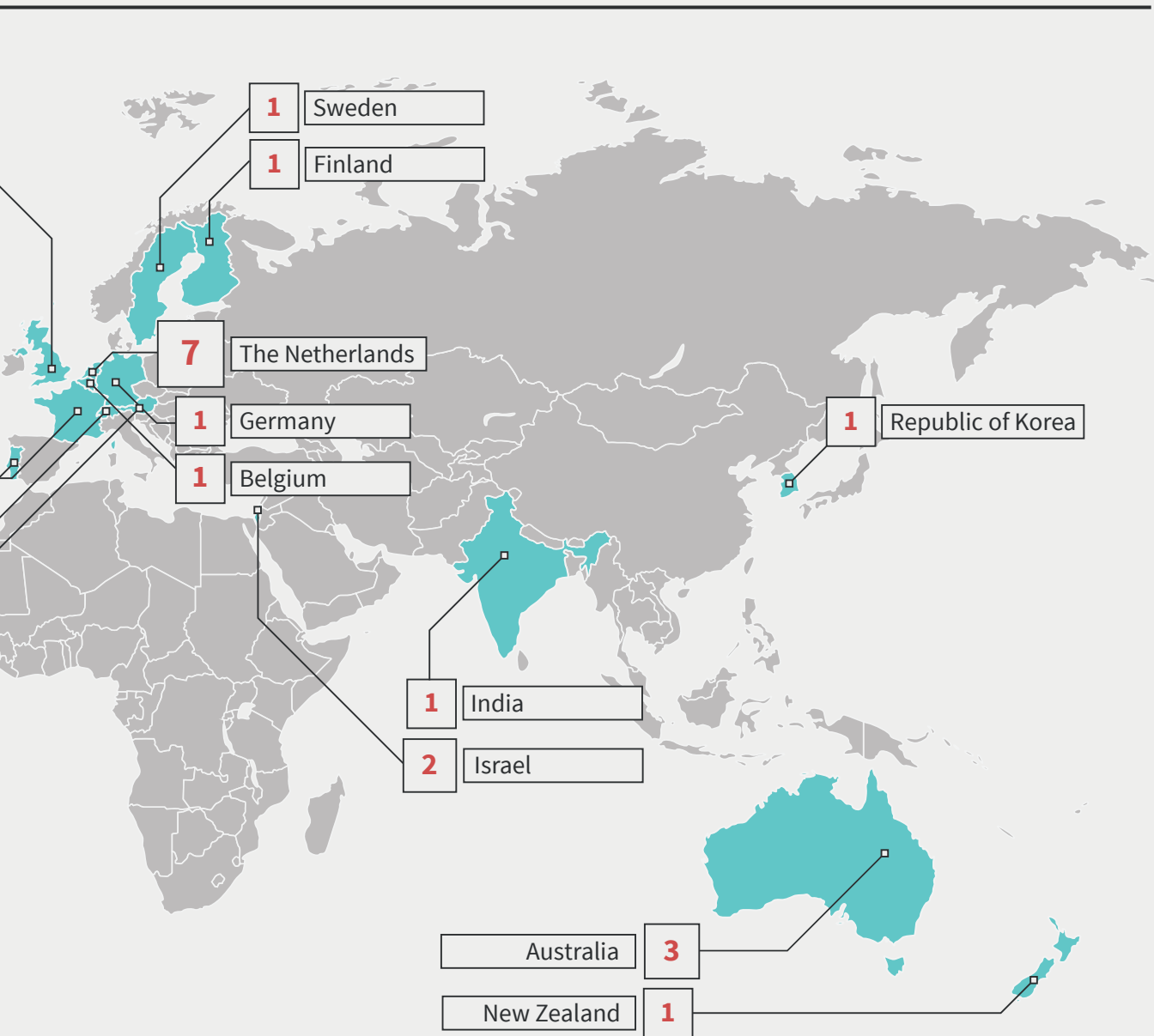
Based on the experiences and lessons learned over the past seven years, five basic criteria have been identified as fundamental for the development and implementation of Impact Bonds: (i) meaningful and measurable outcomes; (ii) a reasonable time horizon to achieve outcomes; (iii) evidence of success in achieving outcomes; (iv) appropriate legal and political conditions; and (v) stakeholders with the necessary experience, will, and dedication to ensure success.

IMPACT BONDS

GLOBALLY AND BY SECTOR



Infographic I "Impact Bonds Globally and by Sector"

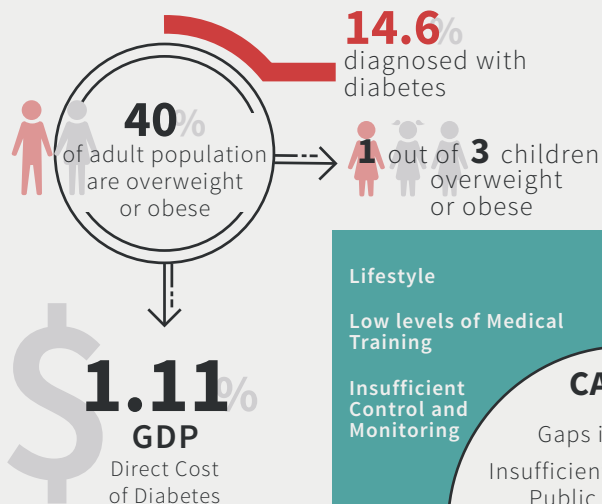


Source: Compilation based on information from Gustafsson-Wright, Gardiner & Putcha (2015) and the Brookings database (2017).

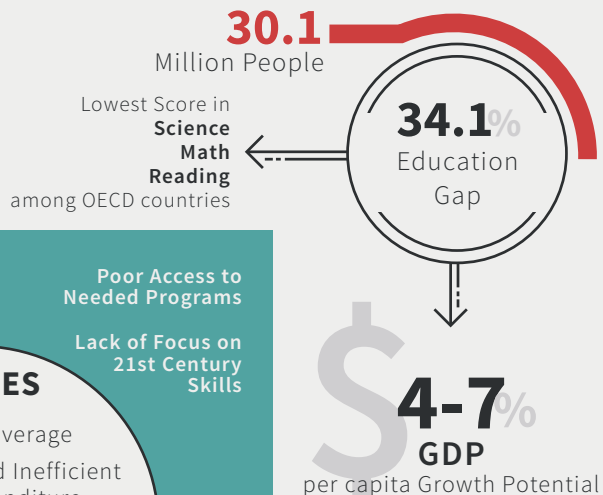
KEY CHALLENGES

FOR THE DEVELOPMENT OF MEXICO

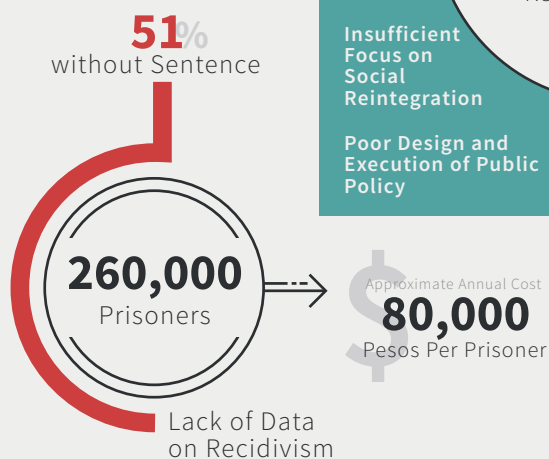
HEALTH



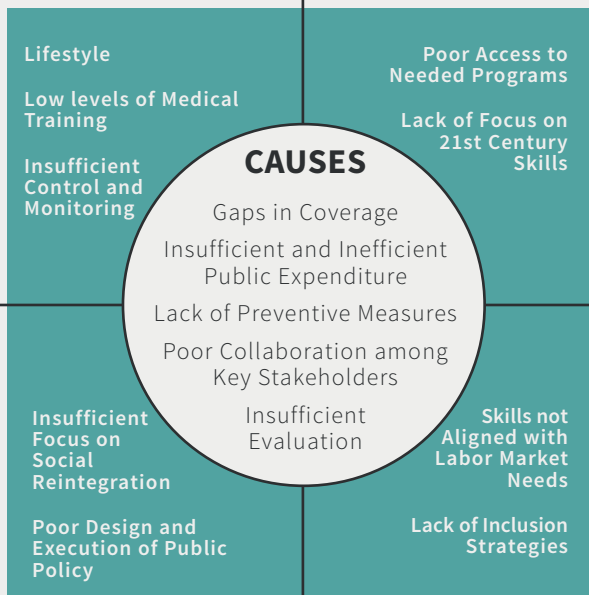
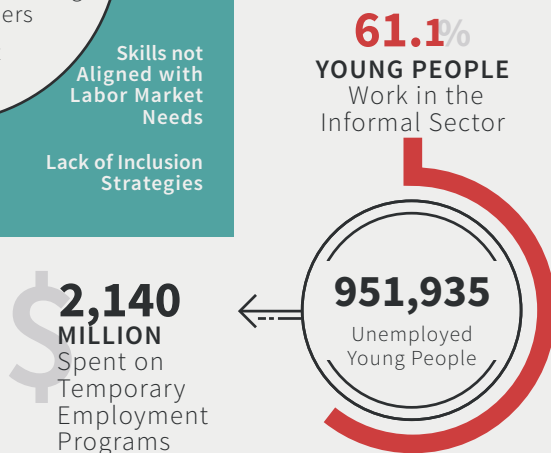
EDUCATION



SECURITY



EMPLOYMENT



In the Face of these Challenges
Impact Bonds promote



Government savings

Effective Spending

Efficiency and Transparency



Focused Action

Local

Innovative



Evaluation and Monitoring Systems

Specific Metrics

Improved Management

Expertise

2. KEY CHALLENGES

FOR THE DEVELOPMENT OF MEXICO

Despite being the second largest economy in the region and the largest exporter, Mexico is ranked eighth among all Latin American countries in the Human Development Index. Forty-six percent of Mexico's population lives in poverty. Impact Bonds represent an opportunity to finance certain aspects of public services, including coverage and quality, in a transparent, innovative and collaborative manner, while also generating savings for the government.

In terms of public health, the primary challenge currently facing Mexico is the increase in non-communicable diseases, such as obesity and diabetes. Currently, approximately 15 percent of the adult population has been diagnosed with diabetes, and this number is expected to increase to 22 percent by 2050. An Impact Bond could be used to provide services with a multidisciplinary or collaborative approach to support patients' necessary lifestyle changes, encouraging interaction between the various stakeholders and the systems that are responsible for prevention, treatment and follow up with diabetic patients.

Another challenge that could be, at least partially, addressed through an impact bond is in the education system -secondary school dropout currently impacts around 35 percent of the population and is more severe in states with high levels of poverty, impacting Mexico's productivity and reinforcing existing negative social structures. Impact Bonds could provide a way to address education quality concerns, as they focus on targeted, timely results. Additionally, by improving public spending and focusing on early intervention and inclusion, impact bonds could also serve as a way to address specific issues or populations.

Currently, there are approximately 951,000 unemployed young people in Mexico. Among those employed, 61 percent work in the informal economy, characterized by low wages, lack of social protection, and few training or professional development opportunities. Additionally, the skills and abilities of the labor force

are not aligned to the actual needs of the labor market. On a global level, Impact Bonds have often been used to address unemployment issues because the programs are able to be implemented within a short period of time, outcomes are easy to measure, and there is often potential to increase economic productivity and generate savings in social programs.

The final issue that might be addressed through the use of Impact Bonds is social reinsertion and crime prevention. In 2016, estimates put the economic cost of violence in Mexico at around 18 percent of the country's gross domestic product (GDP). Additionally, according to the National Institute of Statistics, Geography, and Informatics (Instituto Nacional de Estadística, Geografía e Informática - INEGI), 260,000 people are currently incarcerated, and the federal prison system spends close to US\$12.50 per prisoner per day. An Impact Bond focused on social reinsertion must address the multiple and complex causes of the issue and focus on comprehensive services to help resolve individual issues which, in turn, can help shift society's perception of released convicts.

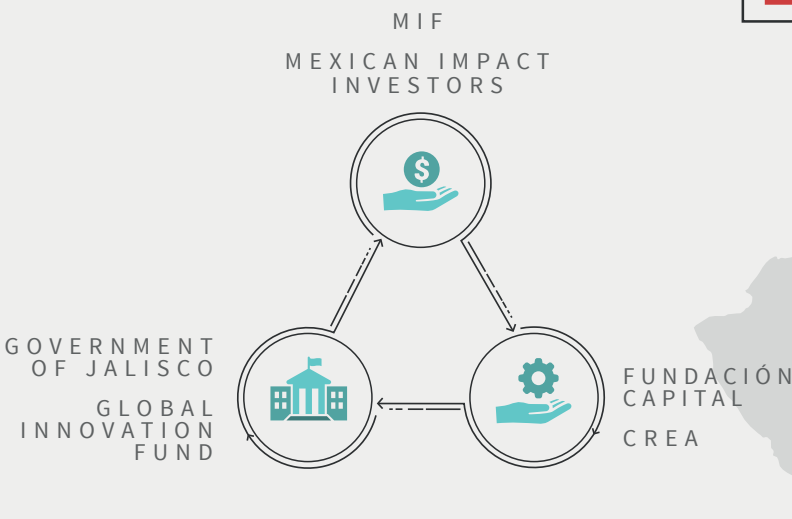
Although these challenges present significant opportunities, it is also important to mention the challenges and barriers that might come into play during the design and implementation of an Impact Bond. An effective communications campaign to inform stakeholders and the public about Impact Bonds is absolutely crucial, as their use might be perceived as an attempt to privatize or outsource social services. Additionally, some of the most significant social issues in Mexico are highly politicized. In these cases, the successful design and implementation of an Impact Bond will likely depend on the support of champions in the public and private sectors. Another possible challenge facing Impact Bonds in Mexico is the quality of the data available, which might complicate the effective identification of the root causes of social issues and the efforts to measure impacts.

THE MEXICAN EXPERIENCE

WITH RESULTS-BASED FINANCING

IMPACT BOND

■ “EL FUTURO EN MIS MANOS”
Guadalajara Metropolitan Area

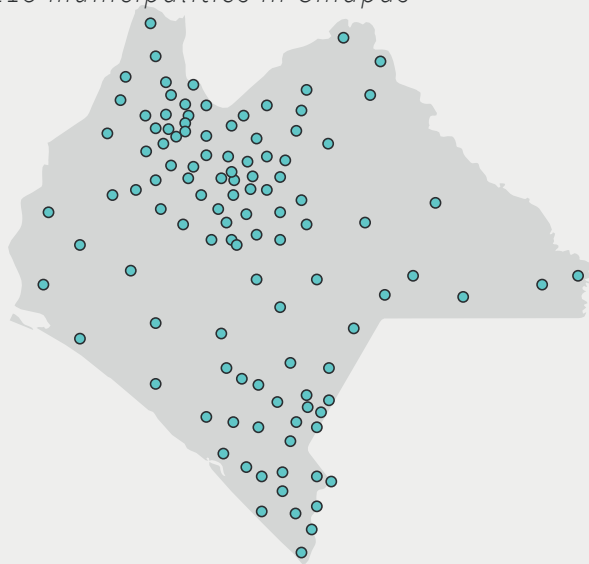


Economic empowerment of
1,320 Female Heads of Households

30
months

PAY FOR RESULTS

■ “ALCANCE”
115 municipalities in Chiapas



Access to education for
43,316 Students

48
months



3. THE MEXICAN EXPERIENCE

WITH RESULTS-BASED FINANCING

Chapter 3 explores the experience to date of implementing Impact Bonds and Results-based Financing projects in Mexico. Impact Bonds were first introduced in Mexico as a result of efforts by the Multilateral Investment Fund (MIF), member of the Inter-American Development Bank Group, to develop innovative instruments to improve the effectiveness of social services in Latin America, as well as to increase available financing.

In comparison to many other Latin American countries, Mexico has a variety of characteristics that make it favorable to implement Impact Bonds. First of all, the Mexican government has experience implementing results-focused social programs. Additionally, there are a significant number of civil society organizations dedicated to providing services to underserved sectors of the population, as well as independent organizations with experience conducting impact evaluations and consultants that are familiar with the technical know-how necessary for the feasibility study and successful design and implementation of Impact Bonds. Local think tanks and academic institutions also contribute important research and analysis on the Impact Bond model as a way to encourage evidence-based public policies in Mexico. Recently, Impact Bonds have attracted the attention of various federal and state-level government agencies and some states are already exploring their feasibility.

This report highlights two examples of cases in Mexico that utilize different Results-Based Financing structures, which encourage a shift away from a focus on the services provided to a focus on results achieved

El futuro en mis manos (The Future is in My Hands) will be the first Impact Bond implemented in Mexico. The purpose is to use various types of training to empower 1,320 female heads of household, increasing their purchasing power, savings, and assets. The Impact Bond will be implemented in the Metropolitan Area of Guadalajara over the course of 30 months. The MIF and Mexican impact investors will provide the initial capital. At the time of publication, the Government of Jalisco and the Global Innovation Fund have committed to repay the investment if and when the Impact Bond achieves the target results.

ALCANCE (REACH) is a Pay-for-Success structure that was launched in 2013. To date, it has been implemented in 115 municipalities in Chiapas. The purpose of the project is to ensure access to secondary education for 43,316 students during a four-year implementation period. The services provided include a combination of personal goal-setting exercises and scholarships to cover the costs associated with schooling. The ultimate goal is for students to enroll in high school, and for them to complete at least a year of secondary schooling. As this program is a traditional Results-based Financing structure rather than an Impact Bond, no private investors are involved. Instead, the local National System for Family Development of Chiapas (*Sistema para el Desarrollo Integral de la Familia del Estado de Chiapas* - DIF) will pay the service provider directly for the results achieved.

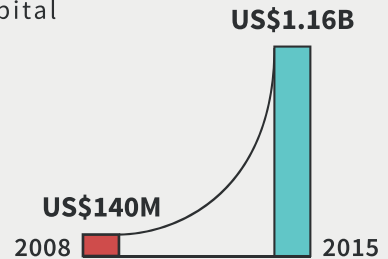
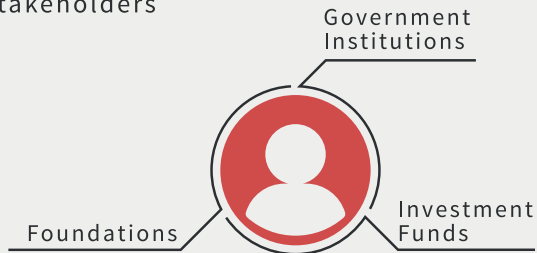
THE ENVIRONMENT

FOR IMPACT BONDS IN MEXICO

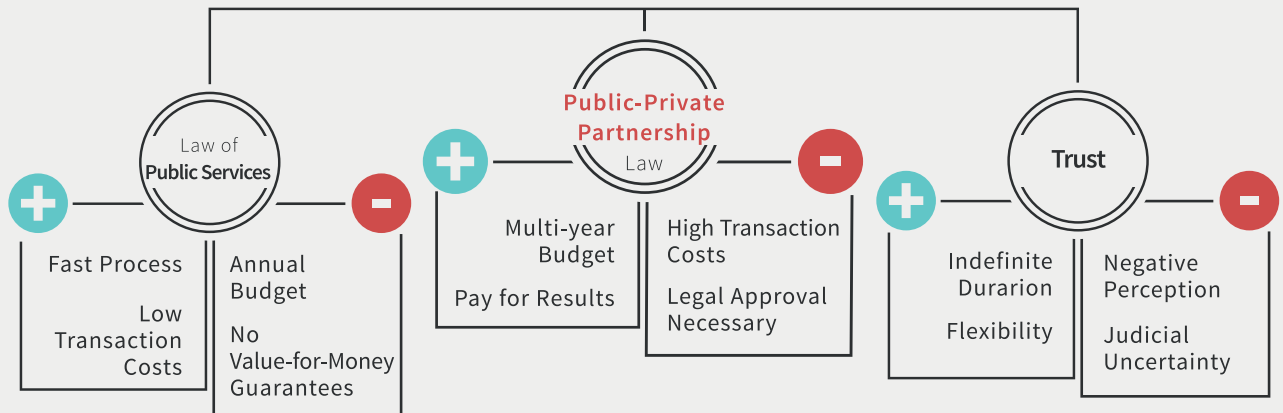
IMPACT INVESTMENT CONTEXT

Main Stakeholders

Increase in Risk Capital



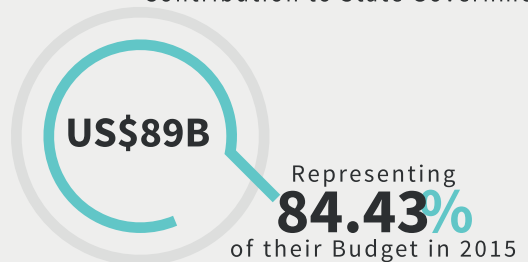
LEGAL FRAMEWORK



POLITICAL CYCLES

FINANCIAL CONTEXT

The Federal Government's Contribution to State Governments



4. THE ENVIRONMENT

FOR IMPACT BONDS IN MEXICO

The requirements for implementing Impact Bonds vary depending on the country, region, and target population. In Mexico, there are a variety of technical requirements that will determine the success of the design and implementation of Impact Bonds, especially in terms of the relationship between the various stakeholders. Chapter 4 focuses on the importance of a thorough understanding of the legal frameworks, political cycles, financial context, and investment environment that will affect the implementation of Impact Bonds in Mexico.

In terms of the legal framework, one of the fundamental conditions that must be met in order to implement an Impact Bond is the ability to commit public resources to guarantee that investors will receive payment if and when the Impact Bond delivers its agreed upon results. At the federal level, the ideal structure is the Public-Private Partnership Law (Ley de Asociaciones Público Privadas). Each project must consider whether the Impact Bond will be implemented in partnership with the federal or state-level government and utilize the appropriate corresponding legal structure.

One of the major challenges in Mexico is ensuring sufficient political support throughout the duration of the Impact Bond project as they require active leadership from the government during the design, negotiation, and implementation stages, which can take up to two years. In order to increase the likelihood of success of each stage, it is essential to take the political cycles into consideration. Ideally, an Impact bond process should be launched at the beginning of the partner administration's time in office. As of 1 June 2017, 19 of the 32 state-level administrations in Mexico were at an ideal stage in their political cycle.

For the financial context, the outcome payer's ability to pay the investors based on the results achieved is critical. It is important for the outcome payer to not just commit to providing funds in the future, but to actually have access to those funds. In Mexico, state governments depend on contributions from the federal government. In 2017, contributions from the federal government to state governments totaled approximately US\$89 billion or \$1.6 trillion Mexican pesos. These funds are used to finance the majority of social development programs and help cover state's debts, ensuring a stable credit rating.

In terms of the impact investing market in Mexico, the level of risk capital has experienced exponential growth, increasing from a value of US\$140 million dollars in 2008 to US\$1.16 billion dollars in 2015. 62 percent of the capital allocated to impact investing activities comes from financial institutions active in sectors where the impact is relevant, such as financial inclusion, health, and agriculture. Although the impact investing industry in Mexico is growing, there are still a variety of challenges that affect its ability to effectively develop mechanisms like Impact Bonds. On the demand side, it is necessary to create targeted strategies to develop impact monitoring and evaluation capabilities of social enterprises, start-ups, and NGOs. On the supply side, it is necessary to create models that are attractive to more traditional investors and philanthropists. Additionally, it is important to promote public policies that create more favorable conditions for existing impact investment structures.

CONCLUSIONS

International lessons learned from the design and implementation of Impact Bonds show the potential of this tool to address complex social problems through a shift towards evidence-based public policies.

Impact Bonds are unique tools for delivering social services, encouraging collaboration between the public and private sectors, incentivizing the development of monitoring and evaluation mechanisms, and focusing on results and the efficiency and effectiveness of social services.

The Impact Bond structure may result in a variety of benefits to all parties involved. For the government, they lower the financial risk of testing social interventions with minimal evidence behind them. Additionally, they represent cost-saving opportunities by shifting the public sector towards a focus on prevention programs and linking the spending of public resources to interventions that achieve measurable results. For investors, impact bonds offer the opportunity to achieve not only financial returns but also significant social impact. For service providers, Impact Bonds offer increased flexibility in how their programs are implemented. Additionally, with the support of other stakeholders, service providers can improve their performance management systems and establish rigorous evidence of the success of their program. Lastly, Impact Bonds benefit the general population by

ensuring that public spending is more transparent and by ensuring that governments operate more effectively on all levels.

Although 81 impact bonds have been implemented around the world as of June 1, 2017, the complicated mechanism still presents challenges for the public officials and additional stakeholders involved. Additional research and guidance on the topic would greatly benefit the market.

In Mexico, Impact Bonds should focus on specific issues and populations that are not adequately addressed by the government and that require targeted spending and comprehensive, multidisciplinary services. The following recommendations are based on an analysis of the legal, political, economic, and investment context in Mexico:

- Ideally, Impact Bonds should be implemented at the start of new administrations to ensure that there is adequate time to conduct the necessary feasibility studies, design the Impact Bond, identify the participating actors, and begin the implementation process. This is particularly true in contexts where the structure is being used for the first time.
- A case-by-case analysis of the strengths and weaknesses of existing legal vehicles should be conducted to evaluate their potential for the implementation of Impact Bonds. Possible legal challenges should be considered from the perspective of investors and service providers.

- It is important to identify organizations with expertise in social interventions to complement the capabilities of local government, as well as to continue to involve new players in the impact investing industry. It is also crucial to strengthen service providers' monitoring and evaluation capabilities so that more of these organizations are prepared to participate in an Impact Bond or other Results-based Financing structures.
- The development of the impact investing industry in Mexico, including the implementation of Impact Bonds, requires the creation of public policies that are focused on increasing both the supply of, and the demand for, impact-focused financial instruments, as well as the establishment of payment guarantees and the implementation of public incentives for private investors.

An open discussion of these issues by the stakeholders involved in Impact Bonds in Mexico will help facilitate the implementation of high-impact social programs that are able to more efficiently and effectively address the major development challenges currently facing the country.