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ASSESSMENT OF THE FEASIBILITY OF IMPACT BONDS IN KYRGYZSTAN

FINAL REPORT

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Final Report:

Assessment of the Feasibility of Impact Bonds in Kyrgyzstan

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Project Name	**Integrated National Financing Framework (000119485)**
Short Title of Assignment:	**Assessment of Feasibility of Impact Bonds in Kyrgyzstan**

Executive Summary

This pre-feasibility study explores the potential for an impact bond to be developed and implemented in Kyrgyzstan in the employability and professional and vocational skills development arena, with a particular focus on youth, women and disadvantaged populations.

Through implementation of the medium-term National Sustainable Development Strategy (2021 - 2026), the Kyrgyz Republic envisages a highly educated nation equipped for technological innovation. It wants a growth trajectory that is less dependent on migrant remittances, natural resources, and a large informal economy. Yet such innovation requires a skilled workforce. A significant share of the youth and adults in the Kyrgyz Republic remain low-skilled and skills do not meet the needs of the 21st century. The COVID-19 pandemic and its negative impact on schooling and vocational training are likely to have further exacerbated skills deficits. The return of migrants to Kyrgyzstan due to the pandemic are placing additional pressures on an already struggling domestic labour market.

Social and development impact bonds (SIBs and DIBs) are a relatively new financial innovation which have quickly attracted interest in the development sector. Under SIBs and DIBs, private investors provide *up-front capital* to an organisation or company to deliver certain services to disadvantaged populations, then receive back their investment, plus a return, *only if pre-agreed results are achieved.* These are called 'outcomes.' Governments reimburse investors in the case of social impact bonds (SIBs), while donors or philanthropic foundations repay investors in the case of development impact bonds (DIBs). SIB and DIB structures do not necessarily bring in *new* (additional) money to a development problem, but instead provide *upfront* working capital and a mechanism that incentivises success. SIBs and DIBs have been commissioned to address a variety of social and environmental problems, that span youth engagement, education, employment, homelessness, rural livelihoods and biodiversity.

Differently from traditional bonds, SIBs/DIBs are intended to improve the *delivery of services to a target population.* In contrast, traditional bonds, including green bonds and sustainable bonds typically finance *physical infrastructure* (e.g. renewable energy or green transportation).

There are 214 known impact bonds across 35 countries worldwide. The majority have been implemented in high-income countries Impact bonds have also been contracted in 14 low and middle-income countries. The overall impact bond market remains fairly small at about US$ 437 million invested to-date. They remain highly niche products with a US$ 3.3 million average upfront capital investment. The internal rate of return on investment for SIBs/DIBs can be as high as 12-13% but also as low as 2%. Some SIB/DIB structure allow investors to obtain higher interest rates or premiums if the project is particularly successful.

Several basic criteria are necessary for social or development impact bonds to come to fruition. These include: meaningful and measurable outcomes; prior evidence of success; presence of skilled service providers; evidence that the impact bond will produce cost savings to outcome payer(s); stable macroeconomic and political environment; appropriate legal framework; interest on the part of potential outcome payer(s); interest from the impact investor community.

Because SIB/DIB structures are complex to design and negotiate, they incur substantial additional transaction costs including intermediary services, technical assistance, evaluation, and legal fees. Being a young market, the start-up costs of SIBs/DIBs have been fairly high to-date. It is important to note that currently there is no conclusive evidence that impact bonds are better than other ways of delivering public services.

In Kyrgyzstan, the government has adopted several key state development programmes which may provide an opportunity to advance a social or development impact bond which strengthens professional and vocational skills in these *state strategic sectors*. These include digital skills, the agro-industrial sector, tourism, construction, energy, industry, transport and mining. It could have a focus on youth and/or other disadvantaged populations, including the “new poor” due to COVID-19. The Batken and Osh regions have been identified as high priority regions for an impact bond.

The measures would be expected to generate cost savings through a long-term increase in productivity and more employment in the formal economy. At the same time, it is also important to note that reaching vulnerable populations can be more costly and complex; as such, the impact bond must set realistic and achievable outcomes. Programmes, in turn, need to be anchored in a clear diagnosis of participant needs which should be analysed in subsequent phases of this work.

Government ministries indicated a strong interest in exploring ways to mobilise new sources of finance for tackling unemployment and building professional and vocational skills in Kyrgyzstan, especially amongst youth. Overall, however the social impact model is not widely understood. Experience with prior results-based financing mechanisms in primary healthcare in Kyrgyzstan showed the approach was not well understood and donors opted to use their own institutional procurement and evaluation processes rather than domestic systems.

Despite these challenges, there are other programmes in Kyrgyzstan, which could be built on and which an impact bond could link to. These include an Asian Development Bank funded ‘Vocational Education and Skills Development’ project and the FAO’s ‘Social Protection Plus/Cash +’ programme. Both provide an opportunity to potentially integrate – and test – an impact bond structure within existing national programmes and institutional structures, rather than arrange it as an independent (and more costly) short-term project. In addition, UNDP in Kyrgyzstan is currently developing a Cash+ concept focused on green jobs and the integration of vulnerable people into the labour market. This provides a further opportunity to align this research with broader impact bond feasibility.

Success Indicators that could be used include: training received, skills improvement (as measured by course completion and certification), job placement and job retention, including after 6 and 12 months. A transaction of not less than US$ 2-3 million is estimated to be a lower bound at which the associated transaction costs (structuring, measurement and evaluation) are considered worth it.

Initial analysis revealed that Kyrgyzstan has a fairly well-developed legal framework for an impact bond. A SIB/DIB could potentially be well covered by the provisions in its law on public procurement, its national investment law, and it Public-Private-Partnerships (PPP) law, which *inter alia* outline standard procedures for public procurement, provide for equal treatment between domestic and international service providers, provisions for dispute resolution, procedures in case of non-performance of contractual obligations, repatriation of profits, and tax advantages.

As such, the bottlenecks for implementation of a SIB/DIB are less on the legislative side and instead relate to issues such as: the lack of familiarity with the social impact bond model; lack of private sector trust in state authorities; poor record on PPP implementation thus far; insufficient local experts to prepare and deliver a social impact bond to a high standard; weak investment climate and poor sovereign credit rating; skewing of the labour market by a high reliance on remittances, which results in a high reservation wage, especially for women, and; too few high quality service providers due to a lack of investment in the sector.

Several next steps are recommended to advance this work:

The rationale for an impact bond needs to be clear. Further clarity is needed on what problem the impact bond is trying to solve. Impact bonds are most relevant as a financial instrument when they provide *innovations* in service delivery to target populations. A useful next step for this work therefore is to survey those involved in current programmes (service providers, students, employers, donors and relevant state entities) to understand where the current challenges and gaps are in current service provision so that an impact bond can be structured to address these.

Outcomes and interventions must be organised around a clear diagnosis of participants'/beneficiaries' needs. Interventions also need to be developed in consultation with local stakeholders. In the next phase, analysis needs to be undertaken by institutions with a local presence to understand target populations' needs and design a mix of interventions best suited to meet those needs.

While impact bonds should test new and innovative ways to reach target populations, there should be clear evidence that interventions have a strong prospect of success, otherwise investors and outcome payers are not likely to back them. In the next phase of work, it will be important to evaluate which service providers have a strong track record in delivering high quality educational and training services. 'Market testing' days where prospective service providers are invited to learn about SIBs/DIBs and how to ultimately bid to become a service provider could be useful in the next phase of work.

A development impact bond is probably more suitable than social impact bond. The Kyrgyz Republic is classified as a lower-middle-income country, and is at moderate risk of debt distress. Borrowing on concessional terms is recommended as the most suitable and sustainable form of loan financing to preserve debt sustainability. Because social impact bonds usually carry market rates of return for investors, and are likely to be repayable in hard currency, a donor agency (or agencies) would likely be the most suitable outcome payer(s), rather than the Kyrgyz state. Several donors consulted for this study expressed an interest *in principle* in the model (like the Asian Development Bank and USAID), but also emphasised that further work was needed to identify suitable labour market interventions. There could also be further work undertaken to see how contributions from the extensive Kyrgyz diaspora could be integrated into an impact bond financial structure.

Further socialisation of the overall model is needed. Interviewees expressed an interest in learning more about success stories from other countries, and UNDP could curate a series of presentations from those involved in SIBs/DIBs in other countries, including Colombia, India, Uzbekistan and Finland.

A plan on how to 'institutionalise' the impact bond will be important to achieve lasting impact. Linking the bond to institutions like the Skills Dev elopement Fund and programmes like Cash+ which aim to reach vulnerable populations will help to integrate the project with existing labour market services and turn it from a (more costly) short-term project into an initiative which could be implemented over a longer-term time horizon.

Looking forward, while it is true there are significant labour shortages in the market, it is important to understand whether these are due to a lack of skills, or due to other factors like poor pay and conditions, or the high reservation wage due to remittances. With unemployment so high, and above official figures, there is also a significant surplus of labour. An impact bond can play a part on the *supply side* to boost skills and employability, but it is important to note that it cannot on its own overcome structural problems in the labour market.

Introduction

In 2020, the UN in the Kyrgyz Republic received financial support from the UN Joint SDG Fund to develop an Integrated National Financing Framework (INFF). The aim of the INFF in the Kyrgyz Republic is to support the government to identify financing options which can support the implementation of the long-term National Development Strategy (NDS) 2018-2040, and the medium-term National Development Programme 2021 - 2026 with a particular focus on the private sector.

It is recognised that achieving the aims of the NDS will require significant investments and financing from a range of public and private sources. This has now become even more important in the context of recovery from the devastating socio-economic impacts caused by the COVID-19 pandemic.

To support the mobilisation of new sources of finance, and enhance the impact of public and private finance, UNDP has commissioned this pre-feasibility study which explores the potential for an impact bond to be developed and implemented in Kyrgyzstan in the employability and professional and vocational skills development arena, with a particular focus on youth and disadvantaged populations.

Through implementation of the medium-term National Sustainable Development Strategy (2021-2026), the Kyrgyz Republic is planning for technological innovation, and a growth trajectory that is less dependent on migrant remittances, natural resources, and a large informal economy. Yet such innovation requires a skilled workforce. A significant share of the youth and adults in the Kyrgyz Republic remain low-skilled and skills do not meet the needs of the 21st century. In the Kyrgyz Republic, job creation is slow and lags behind the pace of demographic growth. The labour market is increasingly seeking adults with strong foundational skills; however, a large portion of adults in the Kyrgyz Republic perform well below this foundational level. Firm and worker productivity remain the lowest in the region. Wide disparities in access to jobs among youth and women exacerbate this challenge.

The COVID-19 pandemic and its negative impact on schooling and vocational training opportunities are likely to have further exacerbated skills deficits. These deficiencies are likely to affect not only today’s students in the short-term, but also the skills proficiency of the future workforce and adults over the long-term. These challenges have been further exacerbated by the return of migrants to Kyrgyzstan, placing additional pressures on an already struggling domestic labour market.