

**High Level Taskforce on Innovative Finance for Health Systems
Working Group II: Raising and Channeling Funds to Countries**

Draft Background Paper

A. Development financing can be tailored to the challenges being addressed

1. Official Development Aid (ODA) from traditional sources has, until fairly recently, not focused heavily on linking the financial design of resource mobilization and delivery mechanisms to the characteristics of the development issues at hand. Largely, funds have been raised and delivered in much the same fashion – through loans and grants and to some extent guarantees – regardless of the development problem being tackled. In contrast, innovative financing solutions seek to address the financial characteristics thereby potentially increasing the effectiveness of a particular operation. This opens new possibilities for the health sector, in terms of the volume of resources raised and also in how effectively the resources can both be raised and deployed.

2. This short note proposes a conceptual framework summarized in the attached chart¹ that could be used as a starting point for Working Group II analysis of how innovative finance can best be applied to strengthen health systems. The framework presented here seeks to break down development problems along three key dimensions:

1. Additionality – increasing the volume and quality of funds raised;
2. Efficiency – financial intermediation and disintermediation to increase the efficiency of financing; and
3. Effectiveness – delivery mechanisms that increase the cost and development effectiveness of the funds.

3. This framework is intended to facilitate the identification of specific concerns that an effective financing instrument or, more likely, combination of instruments should address. The logic behind this approach and examples of questions that can be addressed by each of these dimensions are briefly presented below.

B. Increasing the volume and quality of funds raised

4. Innovative finance has the potential to tap quantitatively additional funds for health systems over and above existing conventional ODA. Additional funds could come from a range of sources including new forms of funding from traditional ODA donors

¹ The attached chart is based on World Bank analysis of the value added of about 100 proposed or existing financing instruments. The brown column identifies a concrete development problem. The yellow column identifies the value added of various financial instruments based on additionality, efficiency, effectiveness in direct response to financial needs of the development problem. The green column indicates the financing solution to achieve this value added and to fulfill the financial need. The blue column provides some better known examples of existing innovative financial instruments.

(such as auctioned carbon permits or the airline ticket levy), private sources, domestic sources, and instruments such as guarantees that leverage additional funds.

5. Assessing the degree of quantitative additionality is complex. Funds raised from traditional donors are fungible with remaining ODA funds that could otherwise have gone toward other development purposes. Earmarking funds to certain uses can in certain cases ensure that funds raised are truly additional but this practice raises effectiveness concerns at the country level. The working group will need to look at how these issues can best be addressed or mitigated. Funds from suggested global taxes and to some extent from the private sector, foundations, individuals and emerging donor countries are examples of sources that may be considered more additional.

6. Innovative financing can also increase the “quality” of the funds being raised, which can be seen as another dimension of additionality. While not unique to health systems, long-term and predictable financing is particularly attractive for this type of institution building that will necessarily carry a strong component of recurring expenditure. Traditional ODA funding is often determined annually or in certain cases on a three-year rolling basis. Longer term horizons can be beneficial to provide incentives to development partners to undertake the reforms and initiate the capacity building programs necessary to strengthen institutions. Examples of funds raised for use over such a time frame include the European Commission MDG contract for financing for up to six years. Another example is the creation of double dividends by charging for the production of negative externalities. In this case, the raising of funds not only provides additionality but also tackles a development problem by addressing a public bad. As an example, the solidarity levy on airline tickets raises funds for UNITAID and, at the same time, contributes to addressing a potential public bad in the form of pollution linked to air travel.

7. In examining the quantitative and qualitative additionality of any innovative finance scheme, the following questions may be useful:

1. *What is the estimated volume of needed funds?*
2. *For what length of time will these funds be needed?*
3. *At what point in time will the funds provide the greatest benefit?*
4. *What degree of concessionality is needed?*
5. *What are potential sources for these funds?*

C. Increasing efficiency of funding through financial intermediation and use of financial markets

8. Financial intermediation and financial markets can adapt the timing of delivery of funds to the need for funding. The efficiency of the financing process may be increased because of lower costs of holding capital and avoiding interruptions of project and program implementation due to inadequate cash flows.

9. Funds can, for example, be frontloaded for high-return investments and non-recurring expenditures. In IFFIm funds are raised on capital markets for immediate use

to rapidly increase immunization rates, while the bonds IFFIm issues are backed by future ODA flows. In this way, long-term investments in immunization can be scaled up and significantly accelerated.

10. Financial intermediation can mitigate financial risks such as currency, interest rate, and counterparty risks. Avoiding the potential costs of these risks using instruments such as swaps or flexible loan arrangements increases the efficiency of the financing process.

11. In order to create an efficient financing process for health systems, questions to be considered, include:

1. *How should the fund flows be timed in order to deliver the funds in the most efficient way (constant, frontloading, backloading, or flexible)?*
2. *What are the potential financial risks (currency risks, interest rate risks, counterparty risks) linked to financing for health systems?*
3. *Which entities involved in the financing process are best suited to carry/mitigate these risks?*

D. Design of delivery mechanisms can significantly enhance development effectiveness

12. Innovative financing instruments can increase the effectiveness of funds, leading to better development outcomes. Funds have a greater impact if they reduce or mitigate risk which countries and individuals face, if they create the right incentives for governments, the private sector, and the aid industry to deliver results, and if they open up new markets or address significant market failures.

13. The effectiveness of fund delivery can be hampered by risks inherent in the environment in which projects and programs operate, such as country risks (macroeconomic risks), natural disaster risks, or commodity price risks. These risks can be mitigated more cheaply with instruments such as insurance schemes, swaps (commodity swaps), or derivatives (derivatives on macroeconomic variables) than through traditional ODA loans and grants.

14. Operational risks can also impede effective delivery of funds. Innovative finance instruments that incorporate well designed incentives can increase the effectiveness of the fund delivery by allocating these risks to those entities that are in the best position to mitigate and manage them. For example, credit-buy downs create incentives for governments to achieve results; output-based aid creates incentives for the private sector to deliver outputs, Advanced Market Commitments (AMCs) create incentives for industries to invest in research and development and to deliver new products.

15. Innovative finance instruments can also tackle market failures. Some innovative finance instruments address these market failures by providing a subsidy. AMCs or the Affordable Medicines Facility for Malaria (AMFm), for example, increase the viability of demand and thereby the supply for goods by promising co-payments to industries, in

essence creating a market. Another market failure derives from unequal market power, where multiple buyers face a monopolistic seller. Innovative purchasing facilities such as UNITAID or Minimum Volume Guarantees can serve to balance market power through bulk purchasing.

16. To determine how innovative finance instruments can be designed to deliver funds most effectively the context of the financial need should be considered:

1. *What are potential exogenous risks (i. e. country risks, natural disaster risks, commodity price risks), if any, that threaten the success of delivery of funds?*
2. *What are potential operational risks that threaten the success of delivery of funds?*
3. *What are the incentives of all involved entities and how should these incentives be designed for achieving development effectiveness, and for delivering results?*
4. *Are negative or positive externalities involved?*
5. *Are there any market failures to be addressed?*

17. Finally, it is important to note that while the framework can assist in answering a number of questions asked of WG II, such as the suitability cost, benefits and development of certain instruments in tackling various problems, it will have to be supplemented by further work to address other issues. This includes the impact on the aid architecture, alignment with domestic policy agendas and how to monitor the use and impact of the funds raised.

