Roots of Impact

DESIGN PRINCIPLES FOR IMPACT-LINKED FINANCE

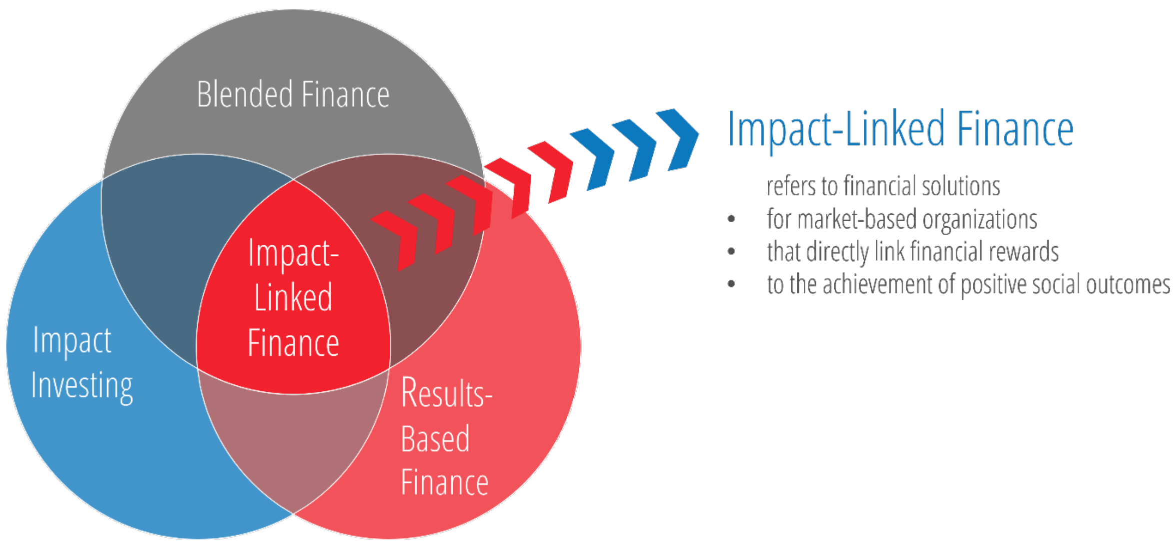
DEFINITION OF IMPACT-LINKED FINANCE

Impact-Linked Finance refers to linking financial rewards for market-based organizations to the achievement of positive social outcomes.

Market-based organizations describe enterprises that have a revenue stream (i.e., paying customers) and follow market principles. They do not need to be profitable and may rely on alternative sources of funding such as grants and donations.

Impact-linked Finance was originally applied to market-based impact enterprises. However, experience shows that it can be very suitable for other market-based organizations as well, e.g., traditional enterprises with great potential for positive impact.

- Directly linking financial rewards means that these rewards are directed to the primary value creator, generally the impact enterprise and not the investor (as is the case in most pay-for-success schemes).
- Financial rewards can take several forms for the target enterprise: From straightforward incentive payments to preferential financing terms (e.g., reduced interest rates or reduced repayment obligations). All forms of rewards are linked to pre-defined, achieved and verified positive outcomes.
- At the core of Impact-Linked Finance is the creation of outcomes (as opposed to outputs) and the measurement of these outcomes or proxies thereof. Measurement should occur wherever feasible, useful, and economically viable for determining the level of financial rewards to be disbursed.



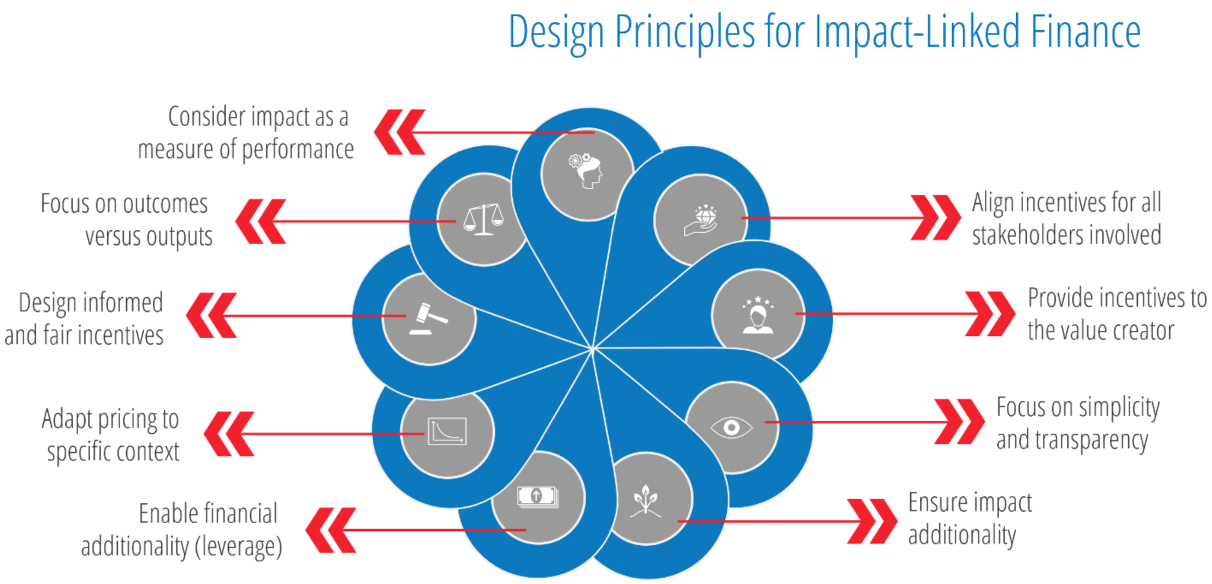
BACKGROUND ON THE DESIGN PRINCIPLES FOR IMPACT-LINKED FINANCE

The practice and concept of Impact-Linked Finance was defined by Roots of Impact, the Boston Consulting Group (BCG), and BCG Henderson Institute in 2019 with the report 'Accelerating Impact-Linked Finance'. The Design Principles for Impact-Linked Finance were published for the first time as part of this report.

The goal of these Principles is to support the most effective use of Impact-Linked Finance and guide practitioners in its application. The initial principles successfully guided the first phase of implementation by pioneering practitioners. The aim from the outset was that the Principles represent a springboard for broader involvement of more practitioners, experts, academics, and other stakeholders who are invited to advance these principles.

HOW TO TAKE THE DESIGN PRINCIPLES INTO ACCOUNT IN INDIVIDUAL TRANSACTIONS

While the Design Principles represent a benchmark for the most effective use of Impact-Linked Finance, not all Principles can be applied at a similar level in each individual transaction. For example, simplicity and outcomes focus, or adapting pricing to context and simplicity, often cannot all be optimized to the same level. Rather, the Principles should be considered and balanced in their entirety. While doing so, ensuring impact additionality is paramount and typically a result of the optimization of the other Principles.



DETAILED PRINCIPLES AND GUIDANCE FOR IMPLEMENTATION

1. CONSIDER IMPACT AS A MEASURE OF PERFORMANCE:

Social and environmental impact can be tracked, managed, and optimized. Thus, incentives should be relative if feasible, rather than rewarding achievement of fixed targets or milestones (granularity according to the development stage of the organization). To ensure maximum effectiveness and relevance over the term of a transaction, metrics and incentive schedules should be regularly reviewed and adjusted as needed - in agreement with the enterprise. Also, longer-term outcomes should be rewarded further down the line. The schedule for periodic reviews must be agreed from the outset.

2. ALIGN INCENTIVES FOR ALL STAKEHOLDER INVOLVED:

Impact-Linked Finance solutions must equitably balance risks and returns to provide aligned incentives for the major stakeholders in terms of social, environmental, and economic value. Seek alignment of incentives with the enterprise’s business strategy.

3. PROVIDE INCENTIVES TO THE VALUE CREATOR:

Rewards need to be directed to the actor who is most central in the value creation process and/or has most decision-making power in where/what impact is being created. If several relevant stakeholders are involved, it can be considered to split them appropriately.

4. FOCUS ON SIMPLICITY AND TRANSPARENCY:

Avoid complicated models. Incentives must be easy to be understood by all stakeholders, with straight-forward and transparent metrics, rewards, and processes. A standardized framework for impact incentives (impact matrix) can be effective in creating transparency and achieving efficiency gains for recurring transactions in specific sectors. When using standardized frameworks, the incentive scheme for an individual enterprise (with selection of most relevant metrics, adequate weighting, and pricing), needs to be tailored to the specific context of the enterprise. The potential for additionality and alignment with the business strategy should be considered. Use benchmark metrics, when possible, otherwise customization is needed.

5. ENSURE IMPACT ADDITIONALITY:

Incentives and rewards should be provided for additional outcomes that would not have happened anyway. If applicable, other capital flows and their anticipated effects must be considered when determining the impact additionality, including effects of investments catalyzed by the incentives. During the term of a transaction, adjustments to metrics or incentive schedules may be made as conditions change (see Principle 1). These adjustments should ensure or increase impact additionality.

6. ENABLE FINANCIAL ADDITIONALITY (LEVERAGE):

The transaction should enable the enterprise to raise investment at the same time or at a later stage. Either incentives are directly linked to additional investment, or the terms are structured to facilitate future capital rounds. In the first case, higher leverage is not always better. Instead, leverage has to be appropriate for the context, and financial resources are a means to create impact additionality.

7. ADAPT PRICING TO SPECIFIC CONTEXT:

The pricing of rewards should be based on objective criteria, but the incentive levels set should maintain flexibility to fit to a given context. Depending on the context, price points for similar outcomes can differ significantly from transaction to transaction.

8. DESIGN INFORMED AND FAIR INCENTIVES:

The level of incentives should be high enough to attract interest from enterprises, but also represent the best value possible for the funder. Pricing should consider potential synergies with the business operations and be determined after an analysis of the enterprise's individual potential.

9. FOCUS ON OUTCOMES VS. OUTPUTS:

Wherever feasible, incentives should be based on outcomes or robust proxies for outcomes, not on inputs or outputs. Impact metrics and requirements for impact measurement and verification should be in reasonable relation to the size of the transaction, the enterprise phase, and the available budgets. Consider designing transactions with evolving metrics: For example, it may make sense to start with evidence-backed outputs that are then replaced by strong proxies and outcomes indicators over time. Or rigor can be increased over the duration of one or more transactions (including incentives for the enterprise to meet higher requirements). Evolving metrics and incentives can help organizations on their journeys to specify and optimize their impact over time.

FUNDAMENTALS, FRAMEWORK CONDITIONS AND ADDITIONAL GUIDANCE

- The impact incentive manager must represent the interest of the funder(s) of the incentives.
- Financial rewards can have several forms. All forms of concessional finance (including taking on higher risk) are a form of subsidy that should be designed according to the Design Principles.
- Ensure that measuring and managing impact performance is in line with international standards, such as the Operating Principles for Impact Management and the Principles of Social Value.
- In case Impact-Linked Finance is used in a blended finance approach, the OECD DAC Blended Finance Principles for Unlocking Commercial Finance for the SDGs should be considered as well.

IMPLEMENTATION GUIDANCE FOR BALANCING TRANSACTION COSTS AND RIGOR

Given the trade-off between transaction costs, effort, and timing on the one hand and value for money on the other hand, three levels of aspiration can be distinguished. Similar to designing transactions with evolving metrics and increasing rigor over the duration of one or more transactions, these levels can serve as a guide for "upward progression" over time.

Characteristics	Basic level	Medium level	Superior level
	Characteristics of enterprise impact measurement		
Impact metrics measured	Outputs with demonstrable expectations for outcomes (evidence required*)	Strong proxies for outcomes (evidence required*)	Outcomes
Impact data availability	Baseline (T0)	Baseline with indications of past performance	Baseline & historical data (T0, T-1, T-2)
Impact measurement & management system	manual ←	→	digitized/ automated
	Possible transaction design features		
Incentive design	Standardized based on similar business models/ToC with individual metric selection and weighting	Standardized based on similar business models/ToC with individual metric selection, weighting, and pricing	Tailored to potential of individual enterprise
Incentive amount (relative to investment size)	lower ←	→	higher
Typical run-time	shorter** ←	→	longer
Transaction costs***	lower ←	→	higher

A transaction, fund, or program can meet criteria from different levels and is assigned to the level in which it meets the most criteria

* If outcomes are not measured, there must be sufficient evidence of causal effect between incentivized metrics and expected outcomes. This may be academic studies that support the assumptions and linkage between outputs and outcomes in general (for the basic level) or in similar cases (for the medium level).

** Only possible when expected results can be generated in the short-term.

*** Possible options for balancing transaction costs/budgets and verification effort:

(Very) low cost: Internal verification with option for external/ independent verification in case of doubts.

Medium cost: Independent verification of IMM system and at least of one incentivized period.

High cost: Independent verification of IMM system and of all incentivized periods.

An independent governance body will ensure further maintenance of the Design Principles and regular consultations of major stakeholders.