IMPACT-LINKED FINANCE:

LEARNINGS FROM EIGHT YEARS

AND IDEAS FOR THE FUTURE

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LET US KNOW ABOUT YOUR PRIORITIES!

We have put a lot of passion, lessons learned, and deep thinking into this report. This makes it particularly useful for practitioners already involved in Impact-Linked Finance. If you are newer to this innovative practice, however, we are eager to learn about your priorities and how we can provide you with actionable insights, including:

- WHERE ARE YOU ON YOUR IMPACT-LINKED FINANCE JOURNEY TODAY?
- WHAT DO YOU NEED TO GET STARTED, TAKE A BIG STEP FORWARD, OR BECOME MORE EFFICIENT IN IMPLEMENTATION?

Let us know what is most important for you in this short survey. Based on your responses and those of other practitioners, we will create a roadmap and options for delving deeper into the most important topics. In the future, you can expect us to share with you:

- Bite-sized insights
- Executive and learning briefs
- Deep-dive sessions on key topics
- Webinars
- Live sessions
- Debates
- ...plus more to come

TABLE OF CONTENTS

EXECUTIVE SUMMARY

Eight years after introducing Social Impact Incentives (SIINC) and four years after defining the practice of Impact-Linked Finance (ILF), we have gathered solid evidence proving that ILF can live up to its promise of "better terms for better impact."

Today, based on a wealth of practical experience, we can demonstrate that ILF is not a product but a structuring approach shifting the impact finance paradigm. It can serve multiple use cases spanning the entire financial spectrum from debt and equity to all kinds of financial innovations. While all ILF instruments share the essential principle of encouraging and rewarding the achievement of additional social or environmental impact beyond business as usual, the key determinant of whether ILF works or not lies in its design.

In this report, we dive deeper by sharing our learnings from the past eight years of implementing Impact-Linked Finance. These reflections help answer the following four questions:

1. What is ILF and what potential does it have?
2. When is it suitable to apply ILF?
3. How to design effective ILF instruments?
4. What can we expect of the ILF practice going forward to capitalize on its momentum?

After explaining our mission and motivation for publishing this report in *Chapter 1*, we first situate the ILF practice in the market in *Chapter 2* and describe its real potential. In *Chapter 3,* we highlight several criteria that practitioners can assess when deciding whether to apply ILF. For example, aligning with the enterprise upfront (and leaving room for re-alignment if circumstances change) is always key. Also, the greater the impact variance is for a particular enterprise or sector, the more ILF is needed. Smartly integrating technical assistance and different design incentives can also unlock greater potential for more enterprises to receive ILF. Furthermore, sector- and theme-specific Impact-Linked funds can enable improved comparability and achieve considerable synergies.

Next comes the question of ILF effectiveness. In our view, the *Design Principles for Impact-Linked Finance* represent the most important benchmark to date for good market practice. These Principles help guide practitioners with ways to deploy ILF more effectively. We share our learnings from applying the Design Principles based on practical insights. We expound upon the centrality of baseline projections, identifying the strongest areas for additionality, and how pricing impact incentives should be construed as an art supported by science.

Regarding data limitations, we reveal our thinking on "what is good enough" and where specific ILF design features and technical assistance can be leveraged to overcome such limitations. Finally, how incentives are priced and targets are set is just as crucial to the strength of an ILF transaction as the potential for sustained enterprise impact after the "exit."

As the ILF practice continues to evolve, we are excited to collaborate with other practitioners to refine the Design Principles collaboratively. To capitalize on this momentum, we have initiated and begun supporting efforts to ensure that these are further developed and maintained by an independent body. As a first step, we have created a soon-to-be-released simplified and open-source Impact-Linked Finance (self-) assessment methodology based on the Design Principles. While far from a panacea, this methodology will nevertheless be a significant guidepost towards a shared understanding of ILF effectiveness.

Over the last few years, it has been exciting to witness more practitioners beginning to embed impact incentives into finance in meaningful ways. We are one of many pioneers, and there are considerable opportunities to maximize the potential of ILF together. In *Chapter 4,* we share a few ideas for how to harness the current momentum. These include:

- Every impact fund should have an impact incentive facility attached so that it can provide better terms for better impact.
- Impact incentives should become an integral part of any future technical assistance (TA). Funding for capacity-building activities is more powerful when complemented by funding for results.
- The time has come for Impact-Linked Funds for each Sustainable Development Goal - and for cross-cutting innovations.
- With Impact-Linked Bonds, ILF can enter the capital markets.

Having already supported multiple organizations to launch their ILF practice, we realized that the accelerating market requires a more scalable solution. We are eager to leap forward towards building the enabling infrastructure for scale. This entails building a (virtual) place where a growing community of practitioners can meet, learn, discuss, evolve, and get inspired – and a digital platform for managing ILF transactions as easily as possible. We look forward to hearing your thoughts and linking impact to finance together!

Let us know what is most important for you in this short survey.

1

THE MISSION:

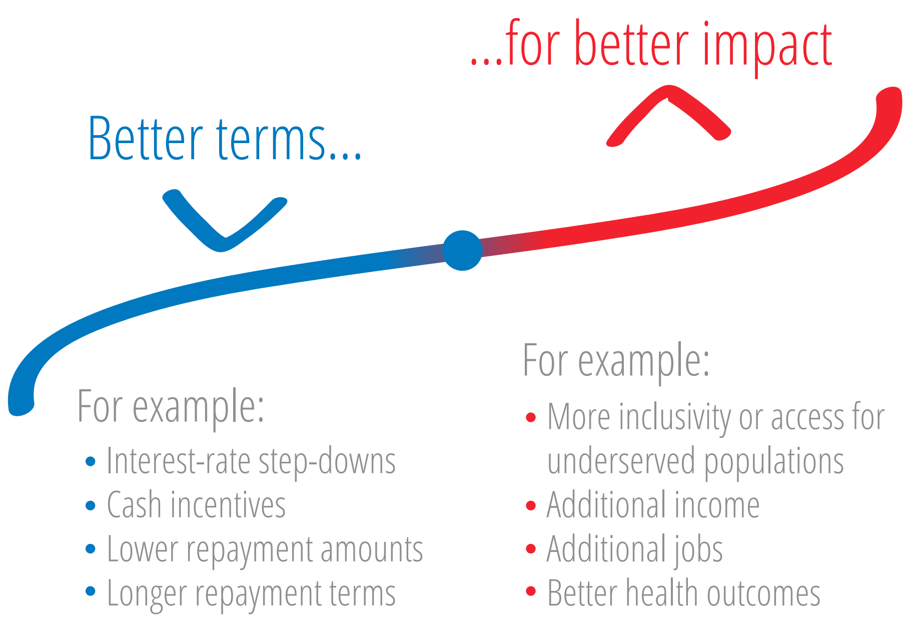
SCALING IMPACT-LINKED FINANCE WHILE KEEPING STANDARDS AND INTEGRITY HIGH

BJOERN STRUEWER
Founder & Co-CEO

NATASHA DINHAM
Co-CEO

The idea of providing "better terms for better impact" is taking off with significantly increasing transactions globally. For good reasons, we think. Evidence shows that Impact-Linked Finance (ILF) can be an effective means for unlocking the potential of high-performing enterprises. Moreover, the practice has proven effective to steer different kinds of enterprises towards achieving positive outcomes that they would not have been able to pursue otherwise. It has a strong potential to lead to greater levels of inclusivity and tangible impact.

Graph 1. The basic principle of Impact-Linked Finance



We couldn't be more excited about this trajectory. Simultaneously, we acknowledge that there are numerous lessons about effective strategies, efficient implementation, and potential pitfalls in the usage of Impact-Linked Finance. To date, we have implemented ILF transactions with more than 50 enterprises and gathered a wealth of experience in doing so. We thought that summarizing our key insights, learnings, and failures would be a valuable resource for anyone interested in providing "better terms for better impact". This is what this report is all about.

Besides, it gives us the unique opportunity to debunk some of the most common myths in this field that we were able to uncover during the past few years. After reviewing the state of play in Impact-Linked Finance and reflecting on its key characteristics, we will share concrete recommendations with you, which will be as practical as possible. We plan to share such findings regularly given the speed of development in this practice.

We strongly believe that to create long-term impact for people and the planet, we need to change both the way impact is financed and how finance is used in general. Our team is passionate about building the field, keeping standards and integrity high, and supporting other practitioners – recognizing that execution makes all the difference.

2

THE POTENTIAL:

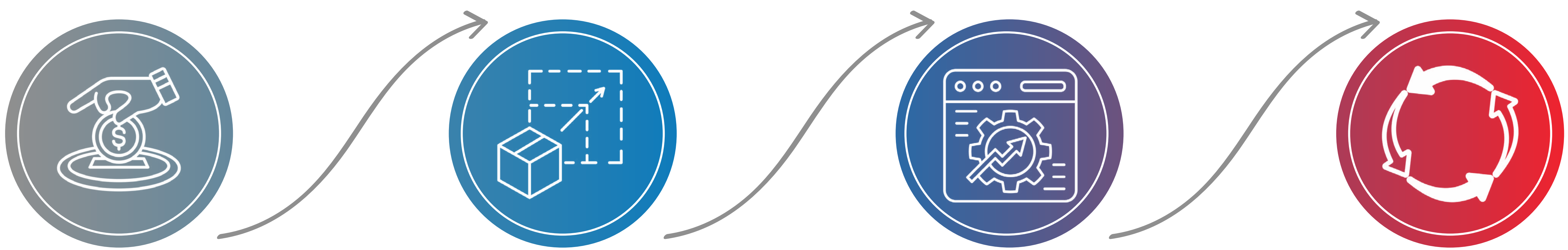
POSITIONING IMPACT-LINKED FINANCE AND ITS PROSPECTS TO DRIVE SYSTEMS-LEVEL IMPACT

THE EVOLUTION OF IMPACT-LINKED FINANCE

Impact-Linked Finance (ILF) was built on the achievements of pioneers who created solutions in results-based finance, impact investing, and blended finance. Like many other innovations, ILF builds on what was previously done and then re-invents, adapts, and applies it effectively in a new context. With ILF, the goal is to unleash the enormous potential of the private sector by incentivizing businesses toward greater and better impact. The basic logic behind this approach is outlined below:

Discover our journey of Impact-Linked Finance

Graph 2. Impact chain of Impact-Linked Finance

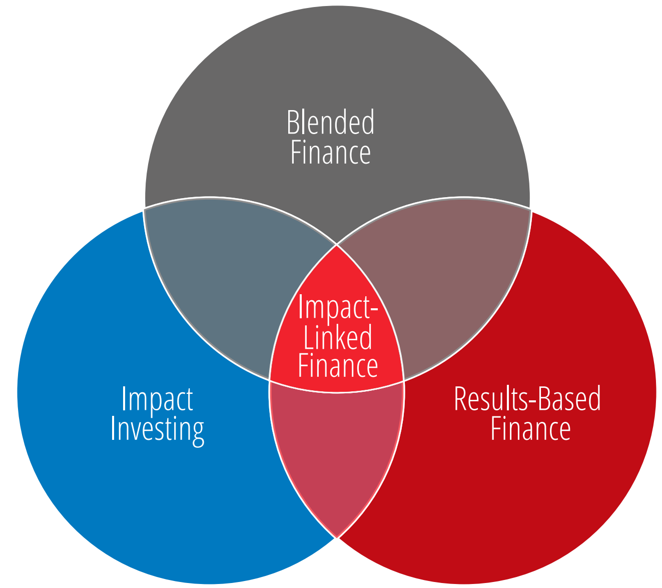


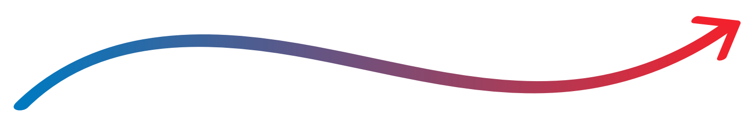
IMPACT REWARDS CAN BE INCORPORATED INTO ANY TYPE OF FINANCE

The journey towards designing ILF began when Roots of Impact and the Swiss Agency for Development and Cooperation (SDC) pioneered Social Impact Incentives (SIINC) and applied this new model to high-impact enterprises in Latin America for the first time in 2016. SIINC is a simple yet powerful solution, as it provides financial incentives for achieving social outcomes directly to enterprises raising investment.

Later, we started to incorporate impact rewards into other financial instruments. As a result, the family of ILF instruments grew over time and now includes Impact-Linked Loans, Impact-Linked Revenue Share Agreements, Impact-Ready Matching Funds, and more. Together with our partners and collaborators, we demonstrated that impact rewards can be embedded into the entire spectrum of financial instruments, and that finance can shift from a risk-return-liquidity mindset to an integrated, 4-dimensional paradigm.

Graph 3. Evolution from SIINC to Impact-Linked Finance
Based on Roots of Impact, Boston Consulting Group (BCG), BCG Henderson Institute





SIINC
pays cash incentives to enterprises for the achievement of positive outcomes - conditional to raising investment.

Impact-Linked Finance
implies a full range of financial solutions directly linking rewards to the achievement of positive outcomes

ILF EVOLVED THROUGH PRACTICAL EXPERIENCE AND HAS PROVEN TO WORK

The idea of "better terms for better impact" has evolved from SIINC to a wide range of different instruments. What they all share is tying financial incentives directly to the achievement of pre-defined outcomes. By conceptualizing and defining this concept in a report in collaboration with the Boston Consulting Group (BCG) and the BCG Henderson Institute called "Accelerating Impact-Linked Finance", which also introduced the Design Principles for Impact-Linked Finance, the term Impact-Linked Finance was coined. Since then, the innovative practice has developed into a field of its own.

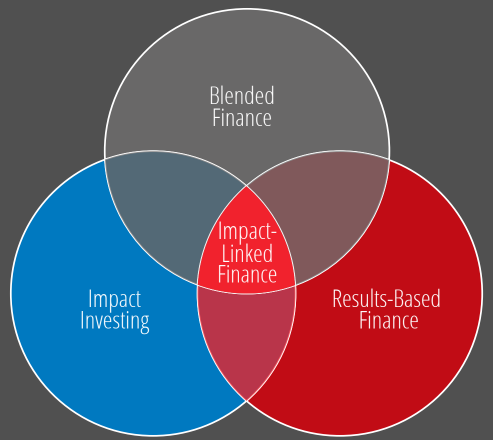
Yet, what sounds promising in theory must be proven in practice. To make ILF effective and unlock its full potential, the specifics of implementation are crucial. One important step in this endeavor is independent evaluations. Collectively, these evaluations have shown that the approach works in practice and does particularly well when closely aligned with the ILF Design Principles. Of course, the most essential measure of success is that the additional impact created through ILF incentivization wouldn't have been achieved by the enterprise otherwise. While financial incentives can help an enterprise raise more or better-aligned capital, their most critical quality is to generate additional impact.

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 only. 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 on outcomes level should occur wherever feasible, useful, and economically viable for determining the level of financial rewards to be disbursed.

Graph 4. Positioning of Impact-Linked Finance in the impact finance practice



Source: Accelerating Impact-Linked Finance, Roots of Impact, Boston Consulting Group (BCG), BCG Henderson Institute

THERE IS STRONG MOMENTUM AND INCREASING APPLICATION BY THE MARKET

Driven by an increasing number of practitioners, there is significant traction for ILF globally.
Below are some key milestones that illustrate how the market has been adopting this practice:

IMPACT-LINKED FINANCE – KEY MILESTONES

2016
- First application of *SIINC for Clínicas del Azúcar* in Mexico and subsequently several other enterprises in Latin America.

2018
- First application of SIINC on fund/portfolio level for *Root Capital.*
- SIINC is being taught in academia with first case studies.

2019
- Launch of the Report "*Accelerating Impact-Linked Finance*", defining the practice (incl. Design Principles).

2020
- Establishment of the *Impact-Linked Finance Fund.*
- *Aceli Africa* uses origination incentives based on the SIINC model with Root Capital.

2021
- First *market report* on ILF by Investing for Good.
- ILF is covered in the book *"Adventure Finance"* by Aunnie Patton Power.

2022
- Several *independent evaluation reports* on the results of early implementation of SIINC programs.
- Launch of new Impact-Linked Funds, e.g. for *Gender Inclusive Fintech* and *WASH*.
- Roots of Impact has closed 44 ILF transactions as of year-end 2022.
- The *IFC report* highlights the role of performance-based incentives (PBIs) as one of the most frequently used blended finance instruments for gender outcomes demonstrating positive results.

2023
- ILF is covered in the book *"Scaling Impact: Finance and Investment for a Better World"*.
- Acumen launches the *Hardest-to-Reach Fund* using Impact-Linked Loans.
- *IDB Invest Report* on Promoting Gender Equality through Performance-based Financial Incentives.

2024
- Start of the project "Scaling Up Impact-Linked Finance" by Roots of Impact and SDC aiming to further build the field.

Now that the moment has been reached where more and more evidence of the effectiveness of ILFs is emerging, numerous new funds and facilities are being announced that explicitly embed impact incentives into their investments.

DIFFERENCES AND SIMILARITIES TO OTHER INNOVATIVE APPROACHES

IMPACT-LINKED FINANCE COMBINES THREE POWERFUL APPROACHES

Placed at the intersection of impact investing, blended finance, and results-based finance, ILF leverages a unique combination of features and distinct characteristics.

For example, impact investors seek positive impact but usually don't incorporate rewards for achieving it. Blended finance typically attracts investors by de-risking but does not encourage the value creator (typically the enterprise) to deliver better impact. And, even when structured around outcomes, results-based finance is not typically a tool used to scale market-based models. Impact-Linked Finance, however, promises to do all of this: It directly rewards market-based organizations for achieving better outcomes as they scale with the help of investments.

Graph 5. Similarities and differences between Impact-Linked Finance and other approaches.

Blended Finance

Specific ILF characteristics

- return-enhancing
- support directly to the value creator who creates additional impact

Other (common) types of Blended Finance:

- De-risking for investors
- Intention and expectation to generate impact, but no means to ensure impact is achieved

Impact Investing

Specific ILF characteristics

- impact-first and catalytic
- aim of impact optimization
- financial concessions in exchange for impact achievement

Other (common) types of Impact Investing:

- Seeking market-rate return, no financial concessions
- Intention and expectation to generate impact, but no means to ensure impact is achieved

Results-Based Finance

Specific ILF characteristics

- outcomes-based financial rewards (not just payments)
- provided directly to market-based organizations
- for additional impact
- in an investment context

Other (common) types of Results-Based Finance:

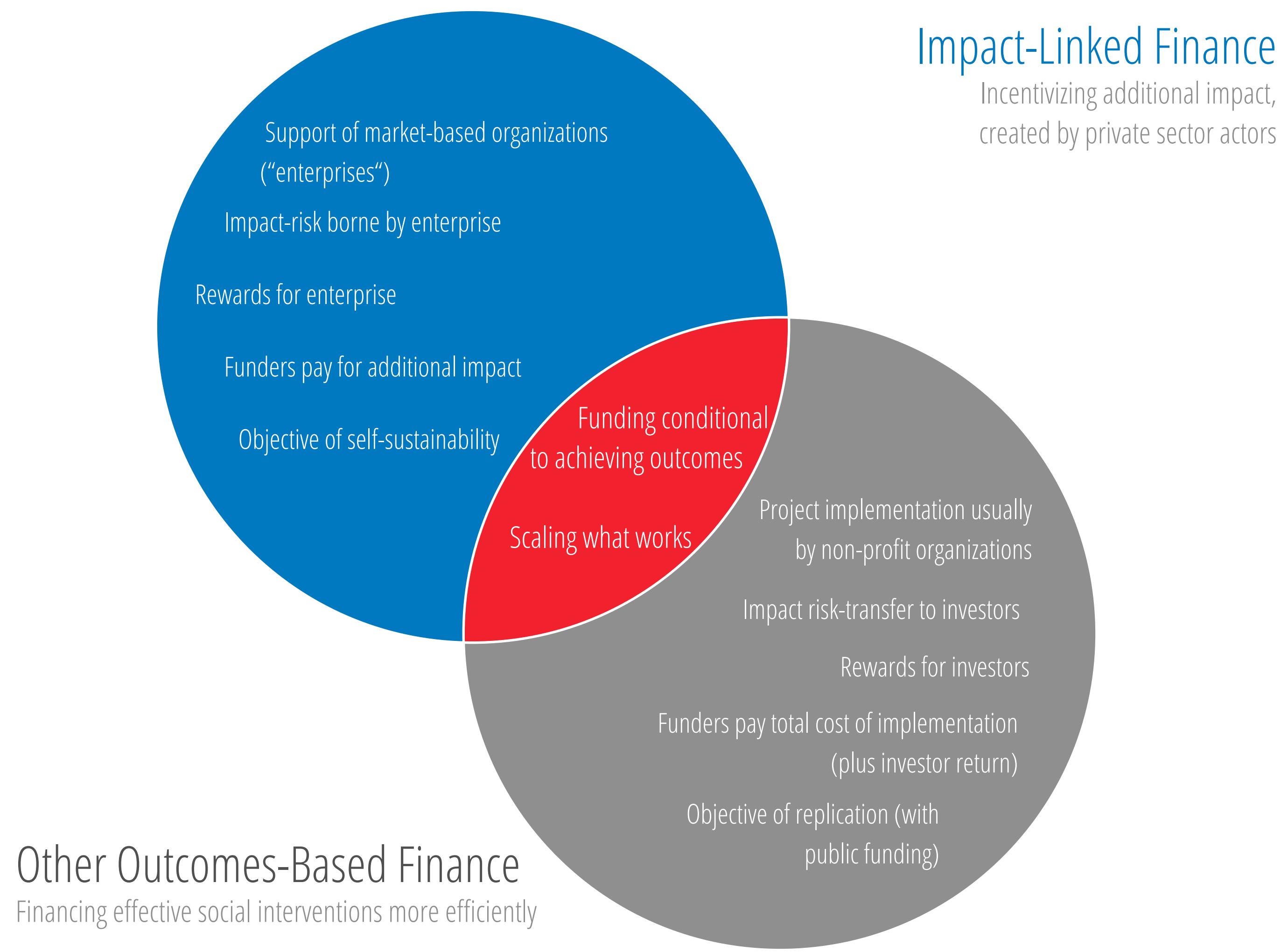
- Paying investors to take the risk of having outcomes delivered (primarily) by non-profit organizations (Impact Bonds)
- Outcomes-based payments for any type of organization, independently from investment
- Paying for outputs, not outcomes, independently from investment (traditional RBF)

ILF IS ABOUT TWEAKING ENTERPRISES TOWARDS BETTER OUTCOMES, NOT ABOUT PAYING FOR SOCIAL INTERVENTIONS

There are fundamental differences between Impact-Linked Finance models and other types of outcomes-based finance. Generally speaking, outcomes-based contracts (including social/development impact bonds) and outcomes funds for non-profit organizations and public sector services aim at financing effective social interventions – and strive to do this more efficiently compared to traditional approaches.

ILF, on the other hand, focuses on incentivizing additional impact created by private sector actors. It can also be used for non-profit organizations that apply market principles. Instead of financing "the intervention" as such, however, ILF is all about nudging the organization towards greater and better outcomes by valuing and rewarding its impact. ILF has different dynamics and thus requires a different mindset.

Graph 6. Similarities and differences between Impact-Linked Finance and other Outcomes-Based Finance



"...SIINC is used for market-based organizations, not for non-profits or interventions that are in the public sector domain. And SIINC payments go directly to the enterprise that creates the value, not to the investor(s)."

SOCIAL IMPACT INCENTIVES (SIINC) IS MORE SIMILAR TO CARBON CREDITS THAN TO IMPACT BONDS

We have often been asked how Social Impact Incentives (SIINC) is different from social or development impact bonds (SIBs/DIBs). Essentially, there are only two similarities: Both models pay for outcomes and both models involve investment. Everything else about SIINC is more similar to carbon credits, with the important difference that SIINC can be applied to address all Sustainable Development Goals, not just climate action. Instead, SIINC used the idea behind carbon finance —paying for positive outcomes —to cover the full spectrum of social and environmental impact, while, of course, avoiding the obvious flaws of the voluntary carbon market (effectiveness and integrity are a question of design, not of the original idea).

The most important difference to impact bonds (SIBs and DIBs) is that SIINC is used for market-based organizations, not for non-profits or interventions that are in the public sector domain. And SIINC payments go directly to the enterprise that creates the value, not to the investor(s). You could say that it's a way to monetize positive externalities by creating an additional revenue stream for the enterprise. In essence, SIINC is a blended finance instrument that is combined with repayable investment.

IMPACT-LINKED FINANCE IS AN APPROACH - NOT A PRODUCT

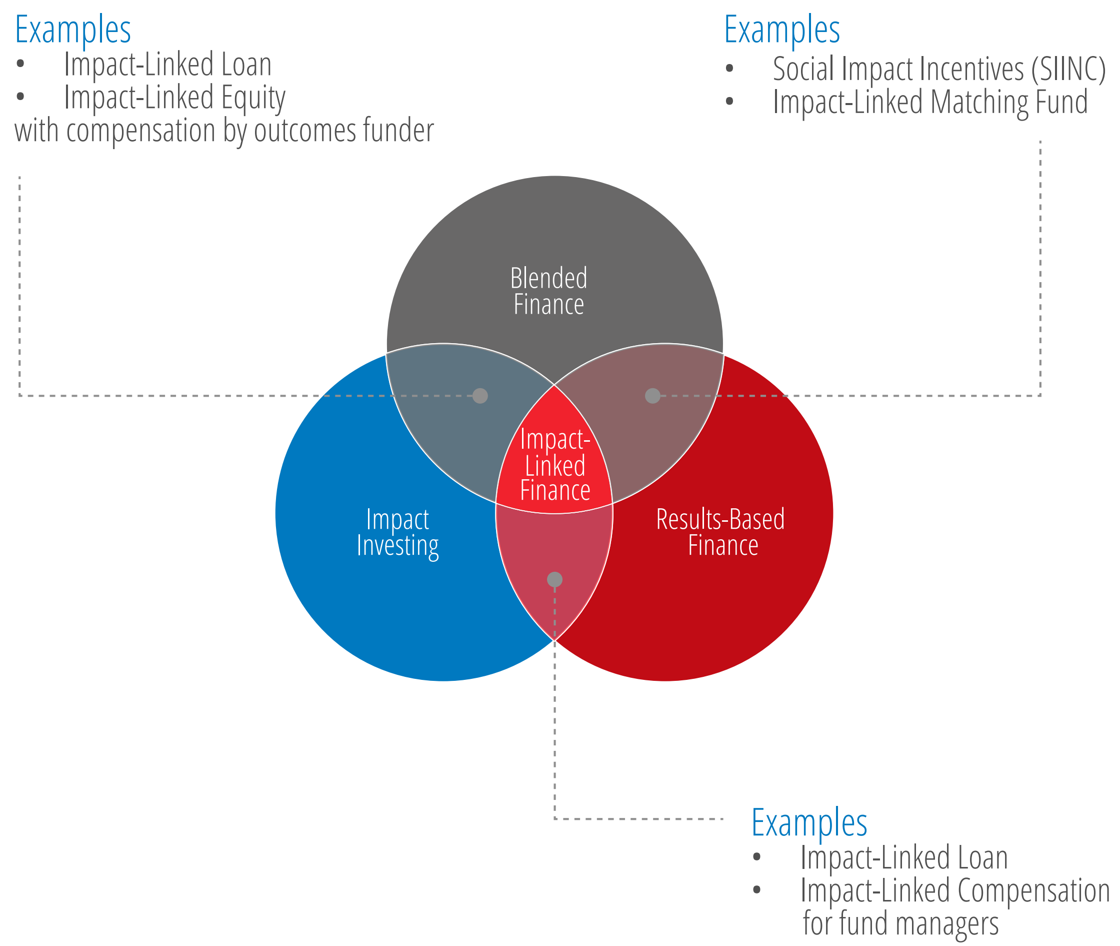
The most important distinction is that Impact-Linked Finance is neither a single financial product or instrument, nor a tool that fits into a narrowly defined scope. It's a structuring approach – and the use cases are manifold. ILF can span the entire spectrum of finance: from debt, mezzanine, and equity to all kinds of financial innovations. Some practitioners may have different names for these ILF instruments, but commonly used terms include:

- Social Impact Incentives (SIINC)
- Impact-Linked Loans
- Impact-Linked Revenue Share Agreements
- Impact-Ready Matching Funds
- Impact-Linked Matching Funds
- Impact-Linked Challenge Funds
- Impact-Linked Equity
- Reimbursable or Convertible SIINC

After years of experimentation and iteration with various types of structures, it is interesting to see that our very first instrument, SIINC is still the most used. In addition, SIINC can include variations that make it suitable for a large number of use cases.

All ILF instruments share the basic principle that they reward the enterprise for achieving a higher level of social or environmental impact. At its core, it is an approach that involves a paradigm shift and can be implemented with a wide variety of structures.

Graph 7. Assignment of various Impact-Linked Finance instruments



HOW TO DISTINGUISH IMPACT-LINKED FINANCE FROM RELATED CONCEPTS

CRITERIA:

- Incentives are linked to impact (measurable outcomes or proxies) and to market-based organizations or solutions.
- Incentives are provided in an investment context.
- Incentive schemes and pricing are based on additionality.
- Subsidy schemes that have standard pricing (not context- or enterprise-specific) or incentives: Such schemes are mostly output-based and are usually not used in an investment context, for example, results-based finance schemes that pay for numbers of products sold, or households connected.

OUT OF SCOPE:

- Social / development impact bonds and other results-based finance structures used for non-market-based organizations.
- There is no investment context.

USE CASES THAT CAN BE ASSIGNED TO ILF DEPENDING ON THE DESIGN, BUT WITH SOME COMPROMISES:

- Granting interest rate step-downs for better ESG ratings: Examples are sustainability-linked loans or bonds that are often lacking incentives for the achievement of concrete and additional positive outcomes (see chapter "ILF will soon hit mainstream").

USE CASES THAT REQUIRE A SPECIAL ASSESSMENT REGARDING EFFECTIVENESS:

- Structures that are driven by investees and their advisors: In such cases, an independent assessment is recommended, as the structuring is carried out on behalf of the recipient of the funding and then offered to funders.
- Incentives for portfolio impact that have highly aggregated/standardized impact targets: Such cases could lead to incentives that are not relevant for the portfolio companies as they are not derived from the individual potential of each company.

WHEN APPLIED ON A FUND OR PORTFOLIO LEVEL, IMPACT-LINKED FINANCE SHOULD BE CAREFULLY DESIGNED

Many of our learnings have been collected while applying Impact-Linked Finance to individual enterprises. However, we have also successfully used this approach on a portfolio or fund level.

Whenever incentives are linked to a fund or financial intermediary, it is paramount that these entities can directly influence the desired results. Suitable metrics may therefore be different compared to those used for single enterprises, and not necessarily as directly oriented towards outcomes. For example, it is possible to directly incentivize an agricultural enterprise or cooperative to improve the income of smallholder farmers. In the case of a portfolio of lenders to agricultural SMEs, however, you would choose *rewards* that prioritize loans to those agri-businesses that have demonstrated clear benefits to smallholder farmers.

In each specific case, it must be assessed whether there is sufficient evidence for using metrics that are proxies for expected outcomes. As the impact chain of a fund or portfolio spans several levels, identifying appropriate metrics is an ambitious task. In an ideal case, incentives are used on both fund and enterprise levels. Of course, metrics and targets must be very well aligned then.

Notably, a complementary and related practice is becoming increasingly popular: impact-linked compensation for fund managers. Examples include impact-linked carried interests or bonuses. To date, early applications of this practice have shown that, depending on the design, impact-linked compensation can create an important alignment between fund managers and their investors.

> *"...it must be assessed whether there is sufficient evidence for using metrics that are proxies for expected outcomes."*

If you are interested in a deeper dive into this subject, we highly recommend the comprehensive research on impact-linked compensation conducted by Aunnie Patton Power and The ImPact.

UNLOCKING THE TRUE POTENTIAL OF IMPACT-LINKED FINANCE

The practice of Impact-Linked Finance (ILF) has its roots in an inconvenient truth: "conventional" impact investing, despite the clear intention to create positive impact, unfortunately lacks both:

(1) impact-first capital that accepts disproportionate risk and/or concessionary returns (also called catalytic capital), and
(2) real incentives that enable enterprises and their investors to optimize for impact additionality.

At least theoretically, blended finance has the potential to change this phenomenon. This is because *catalytic capital*, an essential element in blended finance structures, is a powerful tool. Typically, blended finance uses this tool only for de-risking a transaction and attracting additional (commercial) investment. Impact-Linked Finance, however, is centered around a different idea: By using catalytic capital to encourage and reward enterprises for *broader and deeper impact*, true impact additionality becomes possible. This is how the idea for *SIINC* came to life. Today, many effective ILF transactions contain a healthy dose of catalytic capital.

Yet, there are also ways to apply ILF without making financial concessions. For example, some lenders provide small interest rate step-downs when impact objectives are met, and meeting these objectives may represent a lower risk to the loan or simply ensure alignment between lender and borrower. It is obvious that the potential to create stellar additional impact with only small rewards is limited. But there's no rule without exception: In some cases, significant impact potential can be unlocked when it hasn't received sufficient attention in the past or even has been overlooked by the enterprise. In the transactions we've worked on, this has often been the case with gender-related impact potential.

Usually, the amount of catalytic capital and the additional positive impact that can be achieved are correlated. What makes ILF exciting is that this correlation is not linear. Searching for the "sweet spot" is one of the most exciting tasks when structuring transactions. For us, impact incentives hit a "home run" whenever they have a transformative effect and lead to exponentially positive impact. This holds particularly true when an ILF-supported enterprise becomes a lighthouse and has a clear *demonstration effect* for an entire sector.

We think that it is important to recognize and appreciate the value of catalytic capital for unlocking the full impact potential of enterprises. But we also need to face another inconvenient truth: In essence, catalytic capital is a form of *subsidy* – and subsidies are considered rare. We would like to challenge this perception in the next section.

THE WORLD RUNS ON SUBSIDIES

Where do all the subsidies come from? Where do we find this important source that powers the creation of additional impact at scale?

First things first: Subsidies are pretty much *everywhere*. They form an intrinsic part of every system, whether in agriculture, energy, water, or economic development. Governments across the globe use subsidies for creating (specific) jobs, switching from fossil fuels to green sources of energy, and building critical infrastructure, just to name a few.

While reliable statistics are scarce, trillions of USD are spent by the public sector on subsidies each year. Our thesis is that these subsidies could be (more) effectively used by incentivizing high-performing enterprises. Using only a fraction of these trillions has the potential to be a game changer for these innovators.

The good news is that some governments have already started to switch to paying for positive outcomes. For example, *they pay for bringing people into quality jobs* rather than spending money on running job centers.

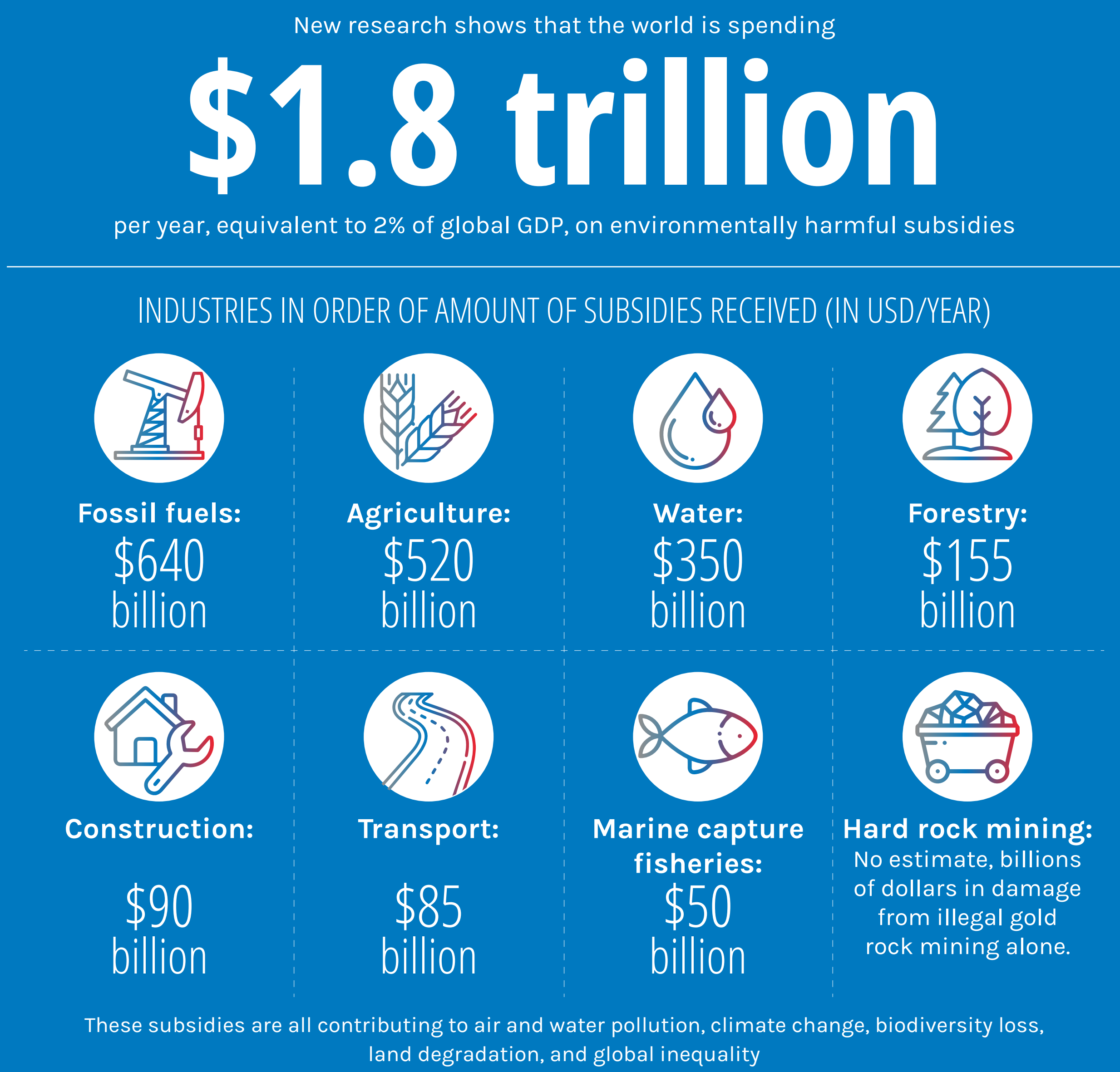
What is truly paradoxical about subsidies, however, is that environmentally harmful ones alone amount to *USD 1.8 trillion annually*. Financing global warming and the annihilation of wildlife through the support of cattle ranching, pesticide use, overproduction of crops, or fossil fuel extraction has reached alarming levels. Notably, the annual flow of these subsidies accounts for more than the total assets under management of the entire impact investing industry that *equals roughly USD 1.2 trillion*.

If we re-directed even a fraction of these flows towards outcomes payments, we could take huge steps forward in rewarding positive impact.

> *"We believe it's just a matter of design to blend huge amounts of subsidies with other forms of capital."*

Graph 8. Distribution of environmentally harmful subsidies

Source: Business for Nature



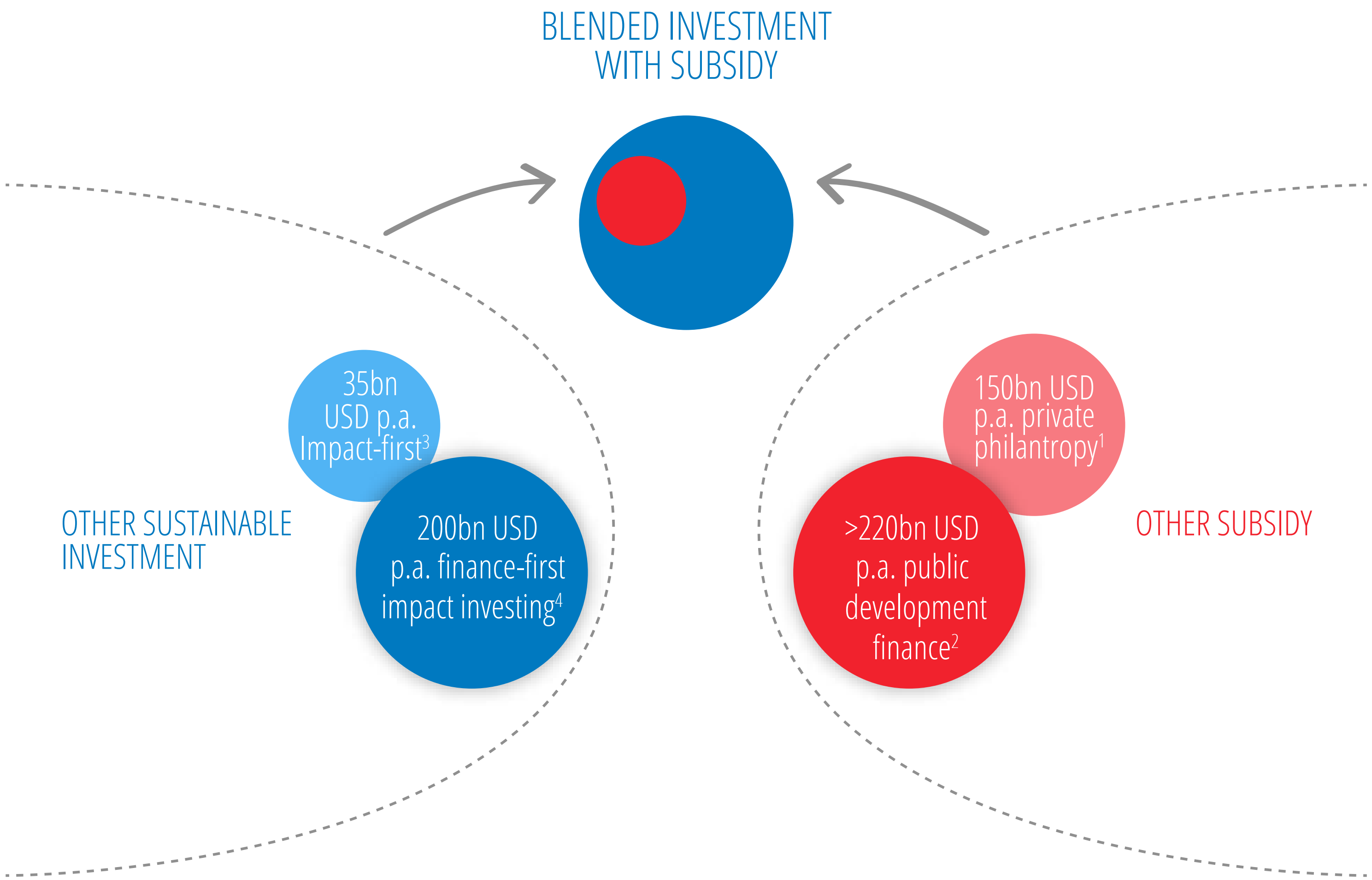
IMMEDIATELY AVAILABLE SOURCES OF CATALYTIC CAPITAL

Tapping into public subsidy schemes is a long-term strategy for Impact-Linked Finance. Other sources of catalytic capital are immediately available, however, and they are significant.

Although international development agencies may not be the fastest movers, they manage large amounts of "impact only" capital. Their spending, formally called Official Development Assistance (ODA), amounted to *more than USD 223 billion* in total during 2023. Many of these agencies have realized that there is an enormous opportunity to engage with the private sector to achieve maximum results with limited ODA resources. Increasingly, more agencies know that Impact-Linked Finance may be an effective way to do this.

With *15% of the annual impact investments* of USD 1.16 trillion targeting financial returns below market rates, impact-first capital, deployed by international development agencies or *other funds*, is a second important source for incorporating impact rewards. Not to mention that the philanthropic sector, with around *USD 150 billion in annual flows*, is increasingly open to new approaches, too. Especially *venture philanthropists* strive to make more effective use of their funding, which, again, has outsized potential to benefit the Impact-Linked Finance movement. Therefore, we believe that it's just a matter of design to blend huge amounts of subsidies with other forms of capital to effectively counteract harmful subsidies and achieve the additional impact that so many of us aim for.

Graph 9. Annual flows (not assets under management) of investment and subsidy



1. *Harvard Kennedy School: Global Philanthropy Report, 2018*
2. *OECD: Official Development Assistance 2023*
3. *GIIN, Sizing the Impact Investment Market 2022 & GIIN Annual Impact Investor Survey 2020: 15% below-market-rate return, assumption 20% of AuM invested p.a.*
4. *The GIIN, Sizing the Impact Investing Market 2022 & GIIN Annual Impact Investor Survey 2020: 85% market-rate return and closer to market rate, assumption 20% of AuM invested p.a.*

IMPACT-LINKED FINANCE WILL SOON HIT MAINSTREAM

To achieve impact at scale, one of the most important sources of capital needs to be tapped. Each year, huge amounts of private assets move through global financial markets and are invested in the best deals in terms of risk, liquidity, and return.

While conventional sustainable finance, which represents a significant share of the mainstream investment market, hardly creates concrete, additional, and tangible positive outcomes, some encouraging trends pave the way for applying Impact-Linked Finance at scale. For example, sustainability-linked loans and bonds follow a similar logic as ILF by incorporating financial rewards for achieving pre-defined sustainability targets.

What is often lacking in these instruments, though, is the focus on additional real-world impact, as there is little incentive for the issuer or borrower to pursue very ambitious impact targets. Instead, they tend to opt for an improvement in Environmental, Social and Governance (ESG) ratings. In other words, they do not optimize for what is achievable, but for what is economically feasible.

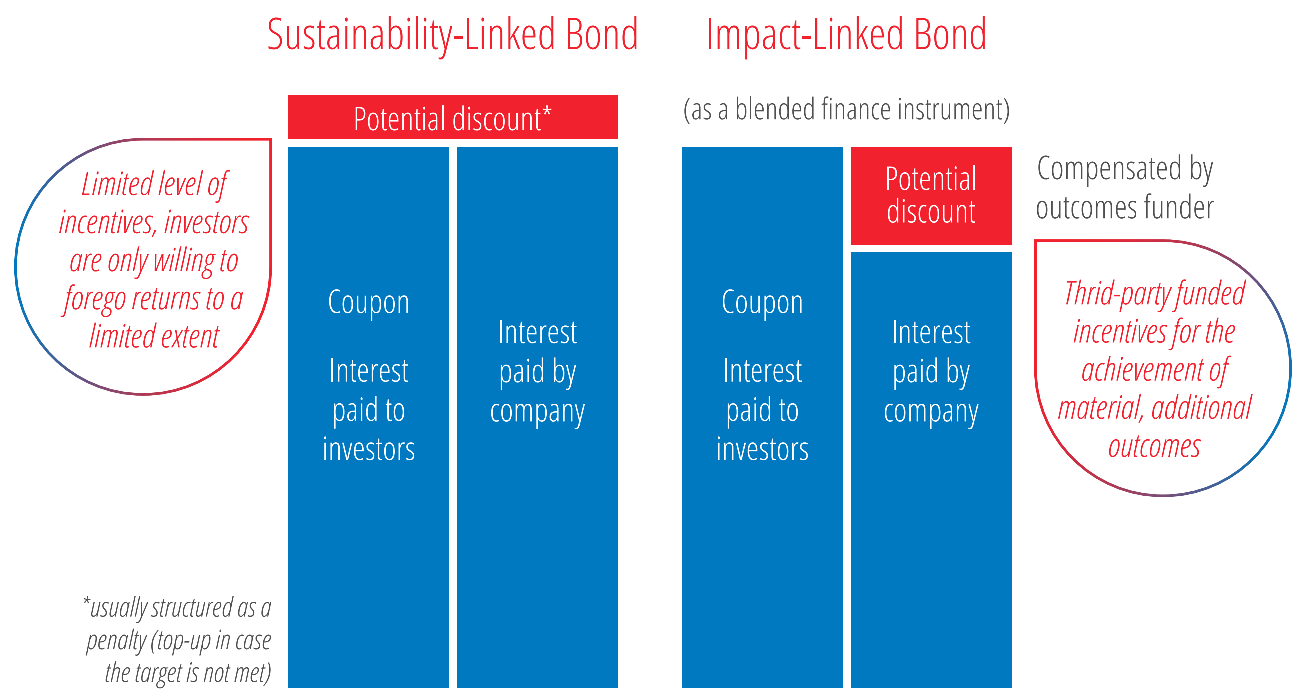
A lack of ambition and materiality is also evident in many loans and bonds structured in the context of "climate risks," commonly understood as *financial risk resulting from climate change*. Since the mainstream investors who provide these loans and bonds require market-rate financial returns, they wouldn't be ready to sacrifice any of these returns for higher impact. Thus, it shouldn't come as a surprise that academics challenge sustainability-linked loans because of the *lack of materiality* of the metrics and the *limited effectiveness* of the incentives.

But how about setting the stage for real-world impact by combining the best of both approaches? What if the advantages provided by sustainability-linked bonds, such as scale, could be wed to those of Impact-Linked Finance, such as concrete and additional positive outcomes?

Just consider the *hundreds of billions* of USD invested in sustainability-linked loans and bonds: Their structures lend themselves perfectly for an impact boost by replacing ESG targets with more concrete and ambitious outcome goals. These targets would go beyond a gradual improvement in the sustainability profile but would clearly exceed business as usual.

Going forward, we also foresee a great opportunity for (public) funders to redirect catalytic capital to support blended Impact-Linked Finance structures with large corporations. We believe that this will occur first at the climate and gender nexus specifically. These first (true) Impact-Linked Bonds will hopefully become an established practice that more effectively leverages the capital markets to achieve impact at scale.

Graph 10. Sustainability-Linked Bond vs Impact-Linked Bond



FEATURE	Sustainability-Linked Bond	Impact-Linked Bond
Discount level	*Typically max. 0.2-0.3 % p.a.*	*According to impact potential (value for money)*
Reward metrics	*Improvement in ESG ratings or other high-level sustainability targets*	*Creation of material, additional outcomes*
Funder of rewards	*Bond investor*	*Outcome funder*
Structuring/pricing of incentives	*Bank or Financial Intermediary (paid by the company/issuer)*	*Independent third party (paid by the outcome funder)*

3

THE PRACTICAL APPLICATION:
KEY INSIGHTS FOR USE CASES AND DESIGN

WHEN TO APPLY IMPACT-LINKED FINANCE

While Impact-Linked Finance (ILF) is no panacea, we have learned that it can be used in a variety of cases to catalyze the potential for (better) impact or keep impact performance high. In this chapter, we share our key learnings to date.

1 ALWAYS, ALWAYS ALIGN WITH THE STRATEGY OF THE ENTERPRISE

The impact to be catalyzed should align with the enterprise's short-term objectives while, at the same time, contribute to its long-term strategy. If this is the case, the seeds planted by impact incentives will fall on fertile ground. There are two possible ways to do so:

(1) Enabling the enterprise to reach its goals at an even higher level.
(2) Jointly discovering an opportunity to unlock a previously hidden impact and business potential.

These two approaches only differ in one aspect: Either the enterprise is already fully aware of its greatest impact potential, or it is still discovering it. Irrespective of the situation, there are various ILF use cases to support the company's strategy with well-designed incentives (see chapter "The range of use cases is broad").

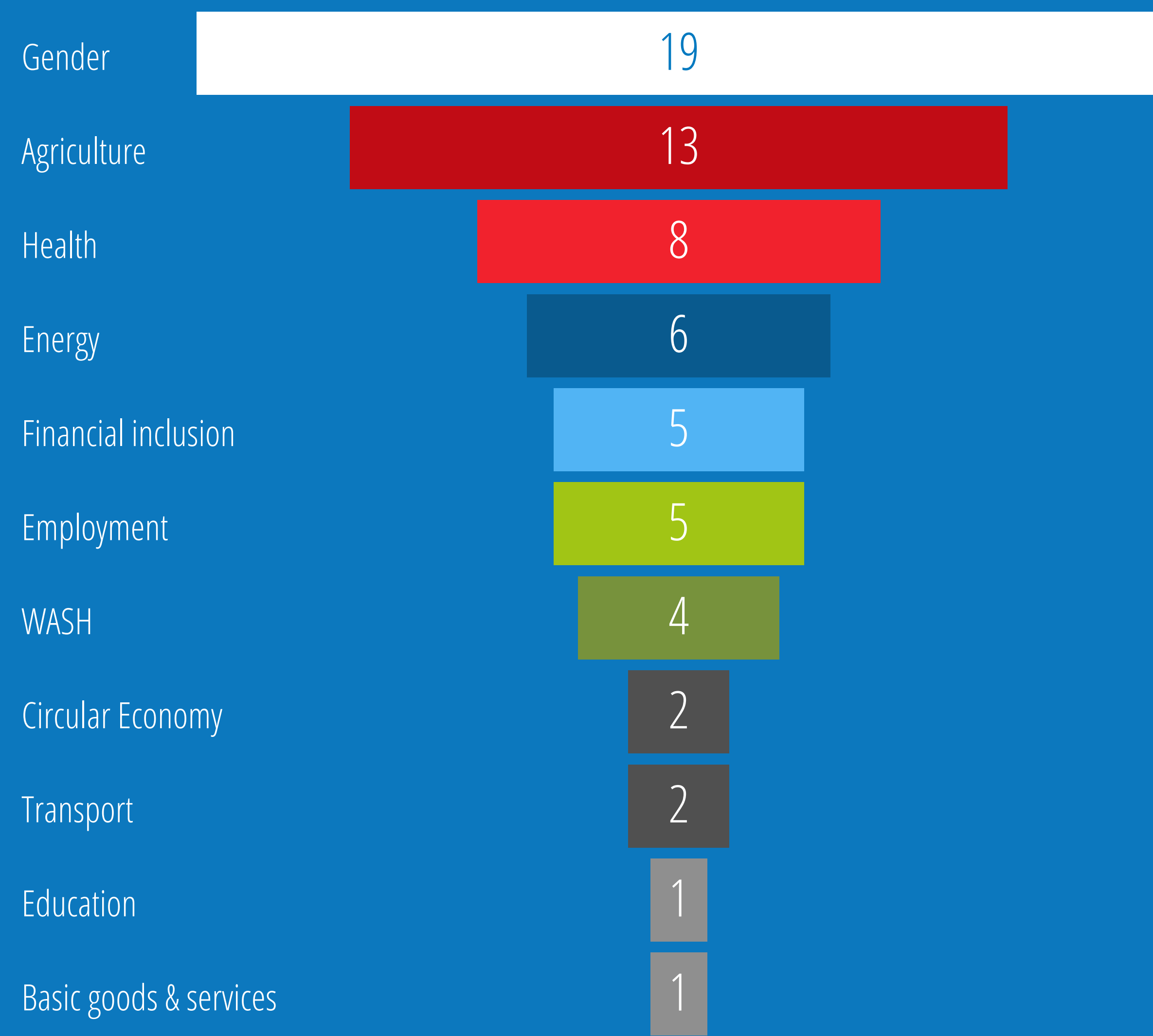
While gaining strategic alignment with enterprises is not only relevant for their short-term success and long-term sustainability, it can also heavily influence how rewards are priced. Once incentives are set with full alignment to the enterprise's business operations, the marginal costs for achieving additional impact over time decrease. In cases where an enterprise would need to be convinced to achieve something not considered a business priority, the result would be the opposite: Impact rewards would have to be high and would not have a lasting effect. Therefore, maximum upfront alignment with enterprise strategy is essential to ensure both a highly effective use of Impact-Linked Finance and long-term sustainability for the enterprise.

Whenever we have been able to achieve this alignment, great success followed suit. In the few exceptional cases where we agreed to incentivize impact metrics that were too unrelated to business operations the results were not very convincing. Funders and practitioners seeking additional impact should therefore beware of defining desired outcomes too narrowly from the outset, as it can lead to higher risks of enterprise misalignment, with unintended negative consequences for both the transaction and impact sustainability.

There are many cases where we were able to explore and unleash the untapped impact potential of an enterprise, including, for example, a customer segment considered to be underserved. In this regard, one example of an often-overlooked area with significant potential for additional impact is gender equality. Despite not managing any funds specifically targeting gender outcomes until 2022, gender was the number one focus topic in our transactions. Although we admit to having a soft spot for this type of impact, it also proved to be the biggest source of untapped impact potential in our eight years of practice. This is why we now also manage funds that explicitly target gender outcomes.

> *"...maximum upfront alignment with enterprise strategy is essential to ensure both a highly effective use of Impact-Linked Finance and long-term sustainability for the enterprise."*

Graph 11. Impact sector focus (on transactions until end of 2022, incl. double counts)



HOW WE DEFINE SUCCESS IN IMPACT-LINKED FINANCE

At Roots of Impact, we define success in Impact-Linked Finance by the additional outcomes created beyond what would have happened anyways without adequate incentives. While determining additionality is challenging, it is also not easy to define and measure the type and level of outcomes that are most desirable or relevant. One can argue about what counts as an outcome and what is just a proxy or intermediate outcome, as compared to the "real" outcome or even broader impact on people and the planet. The results sought and incentivized, as well as the measure of success, often depend on the perspective and on the mandate different organizations have. What counts most for some are high-level changes, such as increased lending to a specific target group like such as women-led SMEs, whereas for others inclusion is the primary benchmark, defined by underserved groups' increased access to specific goods and services.

Primarily, we use ILF to incentivize outcomes that are as specific, material, and tangible as possible. Our transactions usually incentivize both impact depth and breadth, for example, the number of rural women reached and the increased quality of their livelihoods. At the same time, we take strong consideration of the commercial viability and sustainability of the business, too. Although we are true believers in the singular importance of incentivizing outcomes, we also need to apply what is feasible in terms of metric design, impact monitoring, and verification. While we may sometimes compromise by using outputs as proxies if we don't have the relevant enterprise data, we do not give up on getting as close as possible to outcome incentivization.

Another objective of Impact-Linked Finance is to catalyze additional capital. We were quite focused on this goal at the beginning of our journey. Today, however, we have a much more nuanced perspective: We learned that, while ILF instruments (especially SIINC) can certainly enable enterprises to raise more or better-aligned capital, the priority is always to generate additional impact. Capital is only an intermediate step up on the ladder towards a better, deeper, larger-scale, and more sustainable impact. Therefore, at its core, Impact-Linked Finance is all about impact additionality, and raising capital is just a means to an end.

2 THE GREATER THE IMPACT VARIANCE, THE MORE ILF IS NEEDED

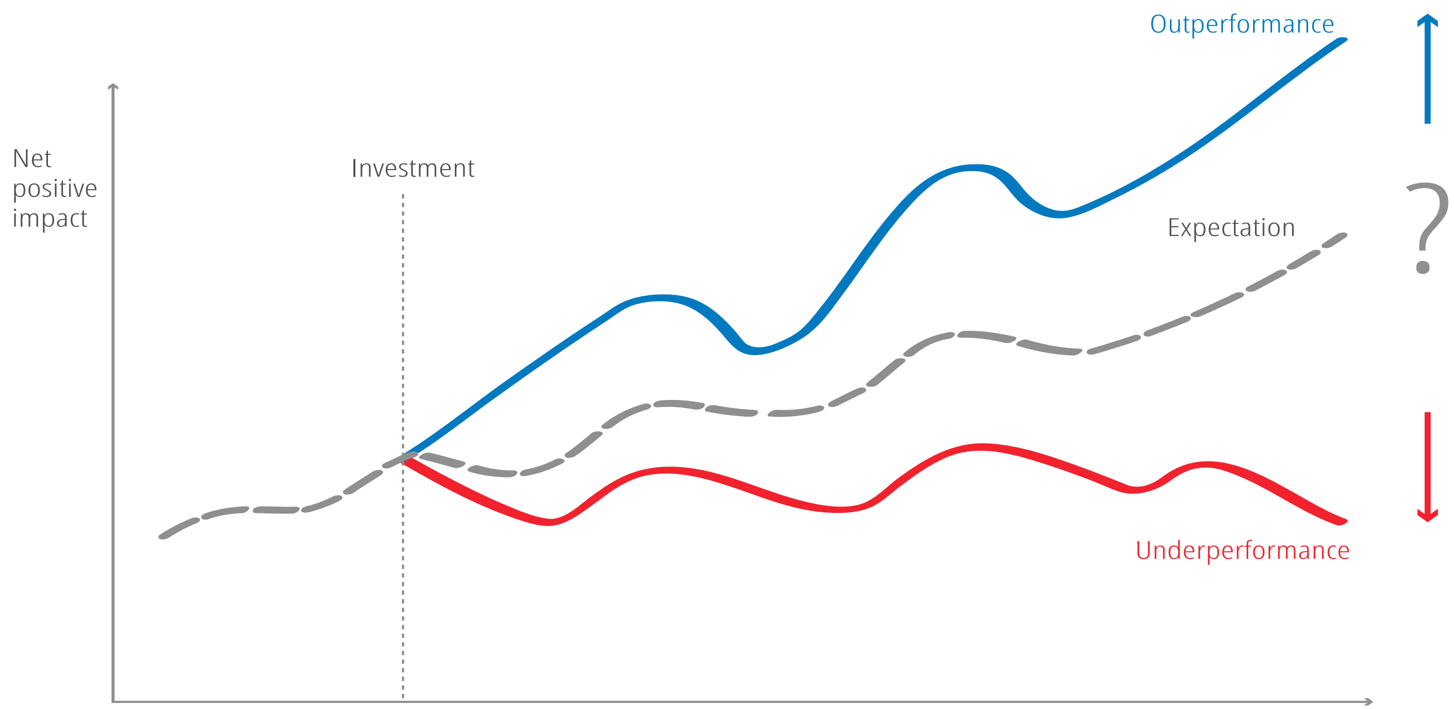
"Impact risk" is a topic that is somewhat neglected in the impact finance space. Defined as the likelihood that an enterprise's impact performance will be different from expectations, we have found that not only is it widely underestimated by investors and catalytic funders, but also treated one-sidedly. Some of our observations about the current approach to impact risk include:

(1) The "constant impact" misconception: Very often, impact risk is not considered by practitioners at all. Once the impact performance of an enterprise has been "proven" in due diligence, it is assumed to be constant or linear in the future. However, reality shows that enterprises are constantly innovating and changing – and their impact changes with them.

(2) The missed opportunity based on "too much impact risk": In the few cases where impact risk is considered, it is often treated as if it can't be managed over time. Consequently, a high (assumed) upfront impact risk leads to the decision not to invest when, in reality, impact performance can and must be managed. This scenario applies specifically to innovations that are in almost constant development and flux, such as high-impact enterprises.

In many cases, the greatest leverage for improving impact performance over time lies in execution. The way an enterprise is managed and how impact is prioritized in day-to-day operations can either enhance or hinder impact performance. Microfinance, for example, is one of the [most established](#) sectors within impact finance. Despite many [standards](#) and best practice examples, it is unclear whether microfinance really "works" or not. Does it help people break out of poverty?

Graph 12. Illustrative representation of impact variance

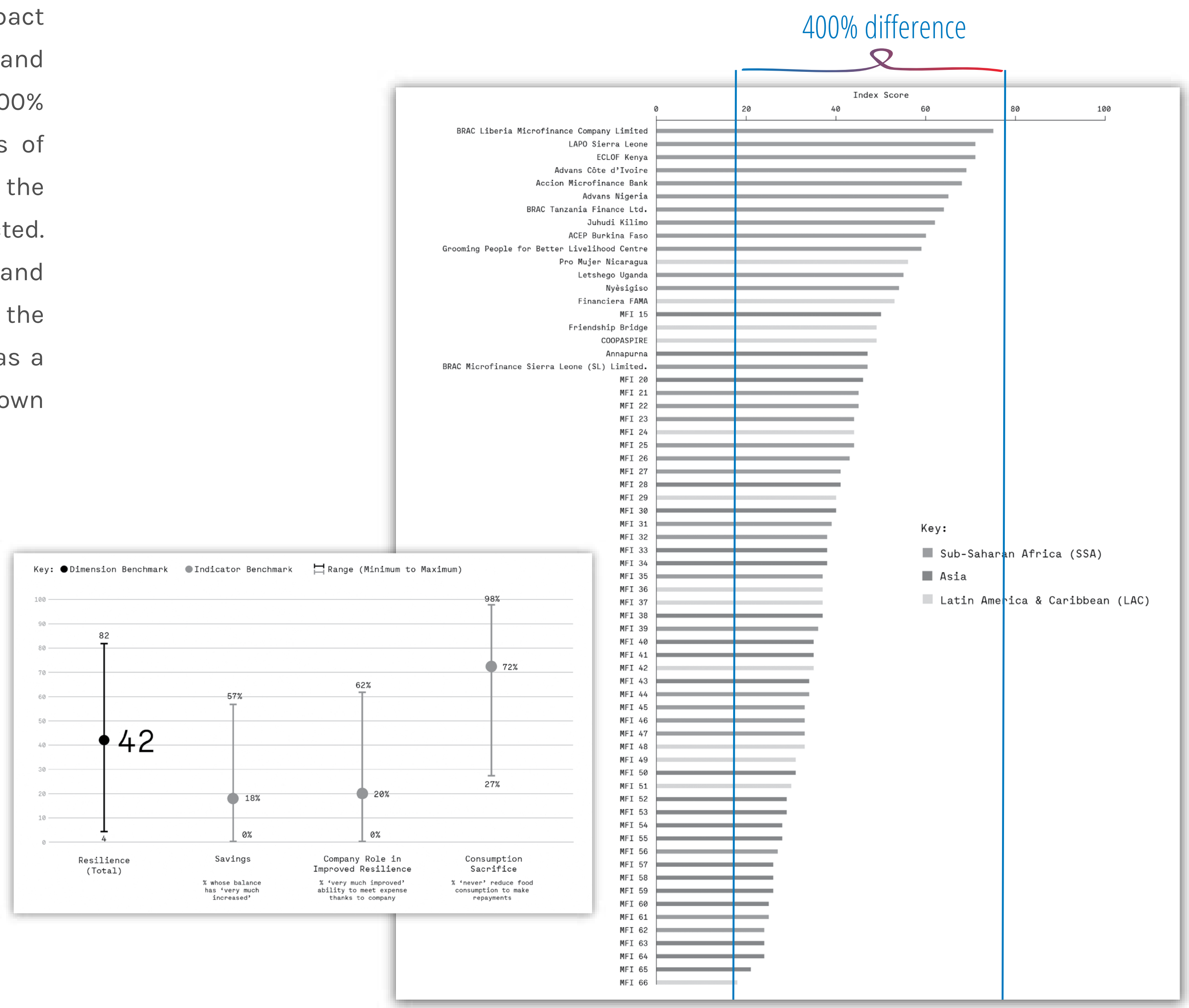


Execution matters, as 60 Decibels is impressively demonstrating with its [Microfinance Index](). This Index regularly benchmarks the impact performance of more than 100 microfinance institutions (MFIs) and surveys their customers. The results are astounding: There is a 400% difference between the top and the bottom performers in terms of customer benefits (57 index points difference). This gap between the best and worst performers is both significant and larger than expected. We refer to the potential spread between underperformance and outperformance as impact variance, as it encompasses not only the risk but also the upside potential. While the microfinance sector as a whole has a high impact variance, each individual enterprise has its own individual impact variance that needs to be managed.

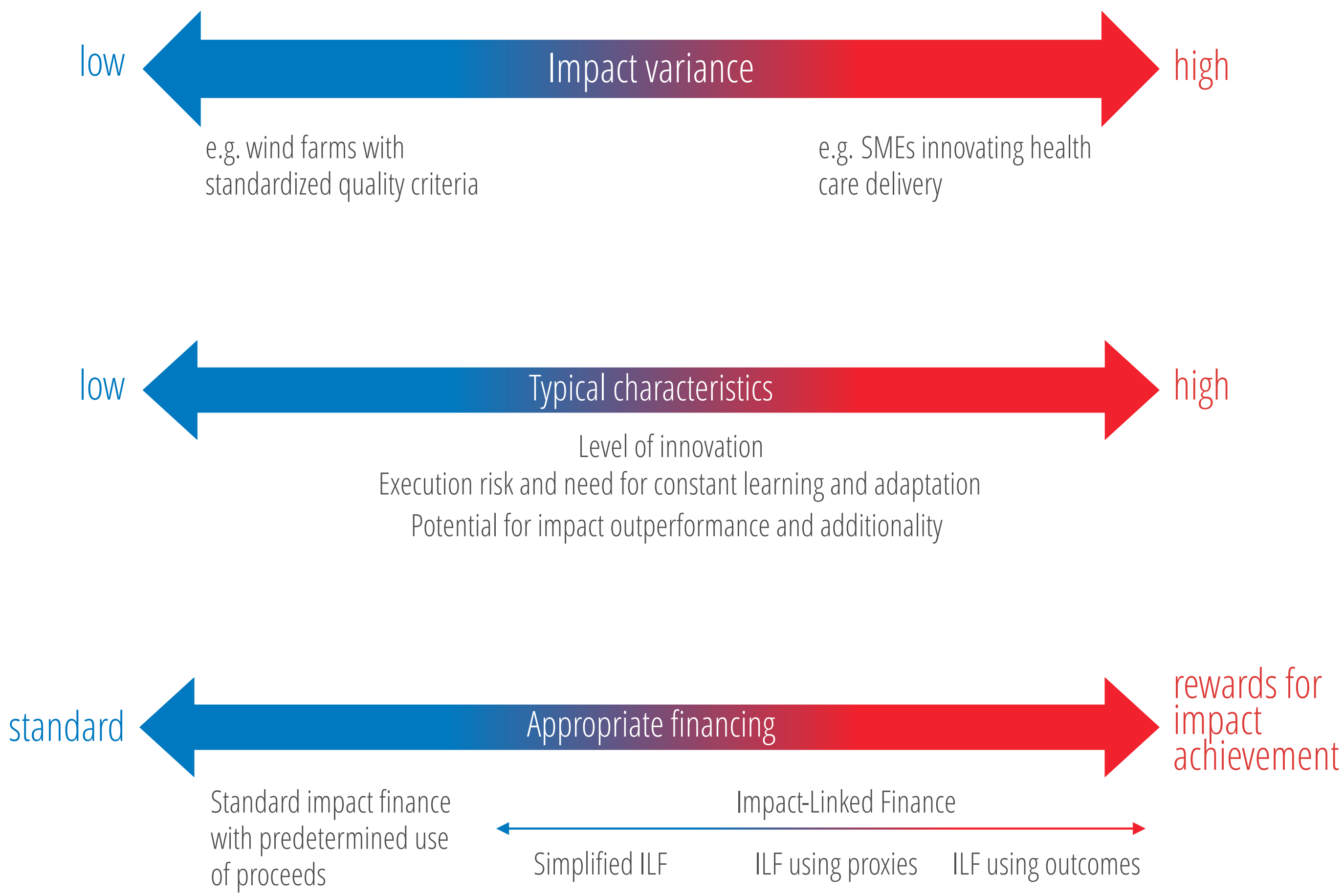
Generally speaking, innovation, creativity, and great execution can deliver outstanding results. However, it is important to note that there are (investment) areas where the degree of impact variance is inherently low (e.g. infrastructure) and others where it is high (e.g. health care). In areas with a high impact variance an enterprise's innovation potential leaves greater room for under- or outperformance.

Impact-Linked Finance is not only a powerful approach to address impact risk but also an effective tool to encourage and enable impact outperformance. Simply put: the greater the impact variance, the more ILF and outcomes orientation are needed.

Graph 13. 60 Decibels Microfinance Index Source: [60 Decibels]()



Graph 14. Appropriate financing depending on the impact variance



3 THE RANGE OF USE CASES IS BROAD

When we launched the first SIINC transaction in 2016, we only had two different scenarios in mind:

(1) If an enterprise is commercially strong, impact incentives can nudge it to create bigger and deeper impact.
(2) If a company is still establishing itself commercially, impact incentives can create an additional revenue stream and make it more attractive to investors.

In both scenarios, impact incentives would help enable the company to scale and deliver impact far beyond the SIINC intervention.

After many years, we now know that once SIINC or other ILF instruments are applied to enterprises with proven models that have access to capital, it's possible to fully focus on optimizing impact performance while the enterprise scales. In contrast, if ILF is applied to an early-stage enterprise in the *pioneer gap (missing middle)*, two approaches must be combined: enterprise development and impact incentivization. Adopting these two approaches naturally leads to higher incentive amounts and a longer runway of support, as high-impact enterprises first need technical assistance to overcome the pioneer gap and scale.

Because these two different scenarios have separate objectives, they should not be compared directly.

Moreover, we also learned that there is greater variety for ILF use cases beyond these two scenarios. We can now distinguish five different use cases that can be addressed with a broad range of ILF instruments and features. The additional three we've identified include:

(3) Unlocking an enterprise's specific, previously hidden impact potential, such as gender impact.
(4) Helping an enterprise stay "on mission:" This is particularly important if the enterprise creates exceptional impact albeit with high levels of impact risk due to market changes, pressure from specific stakeholders, or other factors.
(5) Creating additionality not only by using incentives, but through the investment itself: ILF instruments, such as Impact-Linked Loans, Impact-Linked Equity, or Impact-Linked Revenue Share Agreements, can help finance the upfront cost of creating high-impact solutions that would otherwise face insurmountable barriers due to funders considering them as too risky. Of course, these instruments also must incorporate rewards for impact performance.

Table 1. Overview of ILF use cases

USE CASES	DESCRIPTION
Unlocking impact potential	*The enterprise is commercially strong and able to raise (commercial) capital. It does have the potential for deepening its impact, but is not particularly focused on it, as there are (perceived) risks or tensions between the business and impact model. ILF helps the enterprise to unlock its impact potential by overcoming (potential) low economies of scale and ensuring that impact creation does not come at the expense of profitability.*
Enabling sustainable impact	*The enterprise is focused on creating deep impact, but needs support to achieve higher profitability, become more attractive to (commercial) investors and generate its impact at scale.*
Targeting specific impact	*The enterprise currently does not have a specific impact lens (e.g. gender focus). Such an impact lens (e.g. targeting women) can even be commercially attractive. ILF rewards the enterprises for implementing a stronger focus on achieving specific impact.*
Encouraging continued impact	*The enterprise is impact-focused and economically viable, but for scaling purposes and/or profitability purposes, there is a concrete risk that it moves away from the impact focus towards lower hanging fruits with higher returns.*
Kick starting impactful solutions	*The enterprise can provide evidence for the impact of a new product/service but requires capital to launch and implement. It sees potential for additional or deeper impact but wants to trial it out first, prior to communicating to a full-scale implementation.*

4 TOO EARLY FOR IMPACT INCENTIVES? SMART DESIGN MAKES ALL THE DIFFERENCE

Originally, we believed that rewarding a very early-stage enterprise for their impact performance wouldn't work very well. At such an early-stage, the enterprise would still be establishing itself commercially, let alone deliver the type and scale of impact it seeks to create. We were also convinced that it wouldn't be fair to lock in such an organization so early on in its development by setting impact goals that it couldn't yet accurately predict nor manage. Indeed, a solid track record and reliable baseline are critical to properly plan future performance and manage it over time.

Thanks to years of iteration, we are now a bit wiser: All these initial beliefs only apply if one assumes that impact performance targets must be set up-front for the entire contract duration and are paid at least once annually. This assumption, however, is not set in stone.

We've discovered that early-stage enterprises with a proof of concept can be viable ILF candidates once specific instruments and features are used. For example, rather than defining annual impact performance targets when the ILF contract is signed, it's possible to afford the enterprise additional flexibility to further develop its impact measurement and management (IMM) system first. Then, once those milestones are achieved, agreement on concrete impact performance targets can more easily be reached.

In addition, relatively simple ILF instruments and features can be used to reward the achievement of a single "golden" impact performance target that represents the enterprise's primary purpose. This can be done, for example, by embedding an impact target in a challenge fund. To share one example: An Impact-Linked Challenge Fund could reward a training and employment company with a staggered bonus for the number of young people placed in decent work by the third year of operation. Of course, this golden impact target would need to be very carefully defined, not only in terms of which young people are targeted, but also how decent work is defined and how people are retained in employment.

The example above demonstrates that ILF is very flexible, and that smart design can make a significant difference. If you would like to learn more about the variety of ILF instruments and features, please go to the recommendations about baseline creation and (evolving) IMM on page 45.

IMPACT-LINKED FINANCE INSTRUMENTS FOR (VERY) EARLY-STAGE ENTERPRISES

Table 2. Impact-Linked Finance instruments for (very) early-stage enterprises

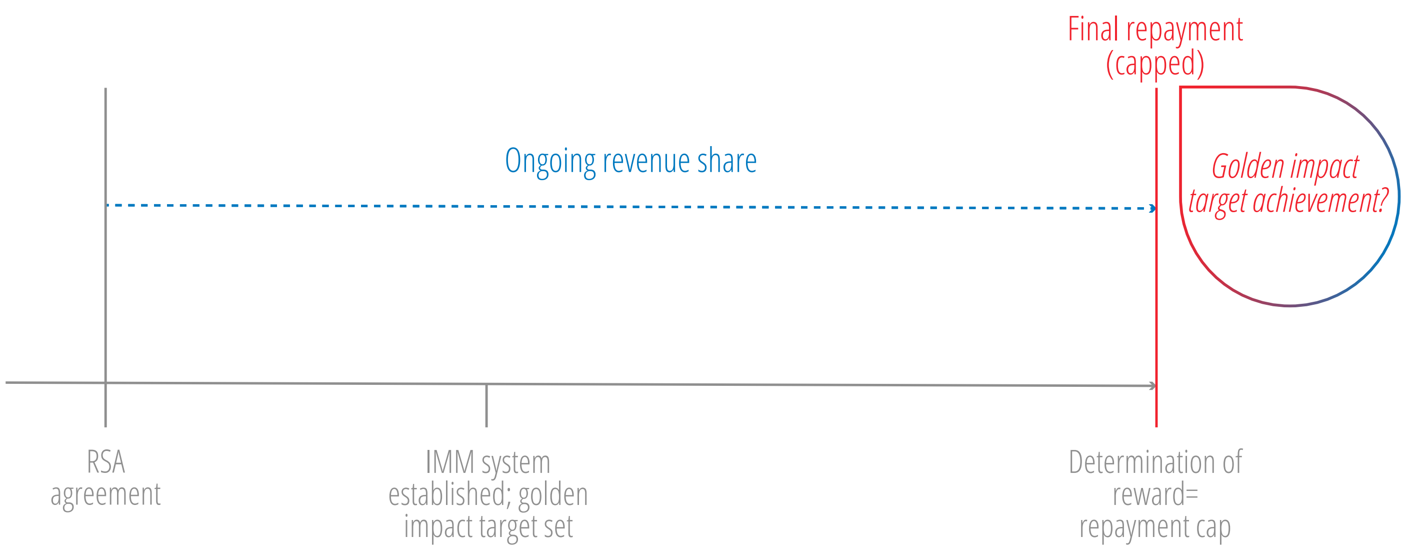
Instrument	Description	Establishment of baseline data	Building up the IMM system	Golden impact target
Impact-Ready Matching Fund	*Non-repayable funding matching private investment 1:1 (capped); disbursement linked to milestones for setting up an impact measurement and management system (with quality controls)*	X	X	
Impact-Linked Challenge Fund	*Cash prize based on competition; additional rewards for achieving a golden impact target (e.g. 50% bonus on the prize)*	(X) depends on design	(X) depends on design	X
Impact-Linked Matching Fund	*Non-repayable funding matching private investment 1:1 (capped); additional reward for achieving a golden impact target (e.g. 30% bonus on original funding)*	(X) depends on design	(X) depends on design	X
Impact-Linked Revenue Share Agreement with impact kicker	*Revenue Sharing with reduction of repayment cap according to the achievement of a golden impact target. Includes establishment of an IMM system and baseline data (see next illustration)*	X	X	X

EXAMPLE: IMPACT-LINKED REVENUE SHARE AGREEMENT WITH IMPACT KICKER

Characteristics

- Reduction of repayment cap upon reaching a golden impact target in 5 years (e.g. reduction of repayment cap from multiple 1.8X to 1.5X)
- The company has sufficient time to establish its impact measurement system, which will be used to verify the target achievement (must be accepted by the investor)
- (TA) support for impact measurement and management (IMM)

Graph 15. Impact-Linked Revenue Share Agreement with impact kicker



5 SECTOR- AND THEME-SPECIFIC FUNDS ENABLE COMPARABILITY, LEARNING, AND EFFICIENT IMPLEMENTATION

As the saying goes, *data is the new oil*, outstripping the old commodity as the world's most valuable resource. Within the ILF framework, this adage certainly holds resonance for impact data and corresponding incentives. As we've seen, there is no better way to build a pool of relevant data than implementing many ILF transactions within the same sector or focused on addressing similar challenges. Data and lessons learned from these transactions are of great significance when it comes to the appropriate pricing of incentives and defining additionality. Further, once relevant benchmarks can be created with sufficient data, they can be leveraged to determine robust sector- or theme-specific frameworks over time.

To advance these goals, we co-initiated the *Impact-Linked Finance Fund (ILFF)* to enable the management of specific funds through pooling of funding from different sources. The ILFF is a multi-stakeholder facility with the purpose of implementing ILF strategies. Through this central platform, we are able to efficiently manage different sector- and theme-specific funds, such as the Impact-Linked Fund for Gender Inclusive Fintech and the Impact-Linked Fund for Gender & Clean Energy (launching soon).

Impact-Linked Funds can also be set up by funders on their own platform. The *Impact-Linked Fund for WASH*, for example, managed in partnership with *Aqua for All*, enables a high degree of comparability and learning because it is entirely focused on supporting entrepreneurial innovations in the Water, Sanitation, and Hygiene (WASH) sector.

IMPACT-LINKED FINANCE FUND

The Impact-Linked Finance Fund provides finance to high-impact enterprises and directly rewards them for positive outcomes generated through their business activities. The Fund, set up as a Dutch foundation, acts as a capital provider for the practice of Impact-Linked Finance by working with ring-fenced Impact-Linked Funds related to specific themes, programs, and geographies, allowing funders to earmark their contributions. More about the Fund: *www.ilf-fund.org*

Source: Impact-Linked Finance Fund

IMPACT-LINKED FINANCE FUND

6 COMBINING INCENTIVES AND TECHNICAL ASSISTANCE IS A WINNING FORMULA

In most cases, the purpose of technical assistance (TA), also known as capacity building, is to strengthen the capacity of an enterprise (or fund) so it can scale in an impactful manner. If capacity is successfully developed, this can lead to better governance, management, accounting practices, and customer service.

The eventual outcome is a robust organization that can create better impact than before. Impact incentives, on the other hand, have a similar objective, with the important difference that they are only paid or rewarded if pre-defined results are achieved.

It may be straightforward, and even beneficial, to directly fund TA activities targeted at improving governance and operations. Yet, we have had good experience with more results-oriented TA approaches for all other types of objectives. This applies above all to those TA activities that aim to develop improved processes or preconditions to create more or deeper impact. Such TA activities include:

- Developing a robust impact measurement & management (IMM) system
- Tapping into a new target customer group
- Developing a gender strategy and action plan

For example, a TA activity may focus on supporting an enterprise (or fund) to develop a gender strategy and action plan to improve gender equality and deliver concrete gender-related benefits. Attaching incentives to such an action plan is sensible, as it significantly increases the probability that the defined actions will lead to the desired results.

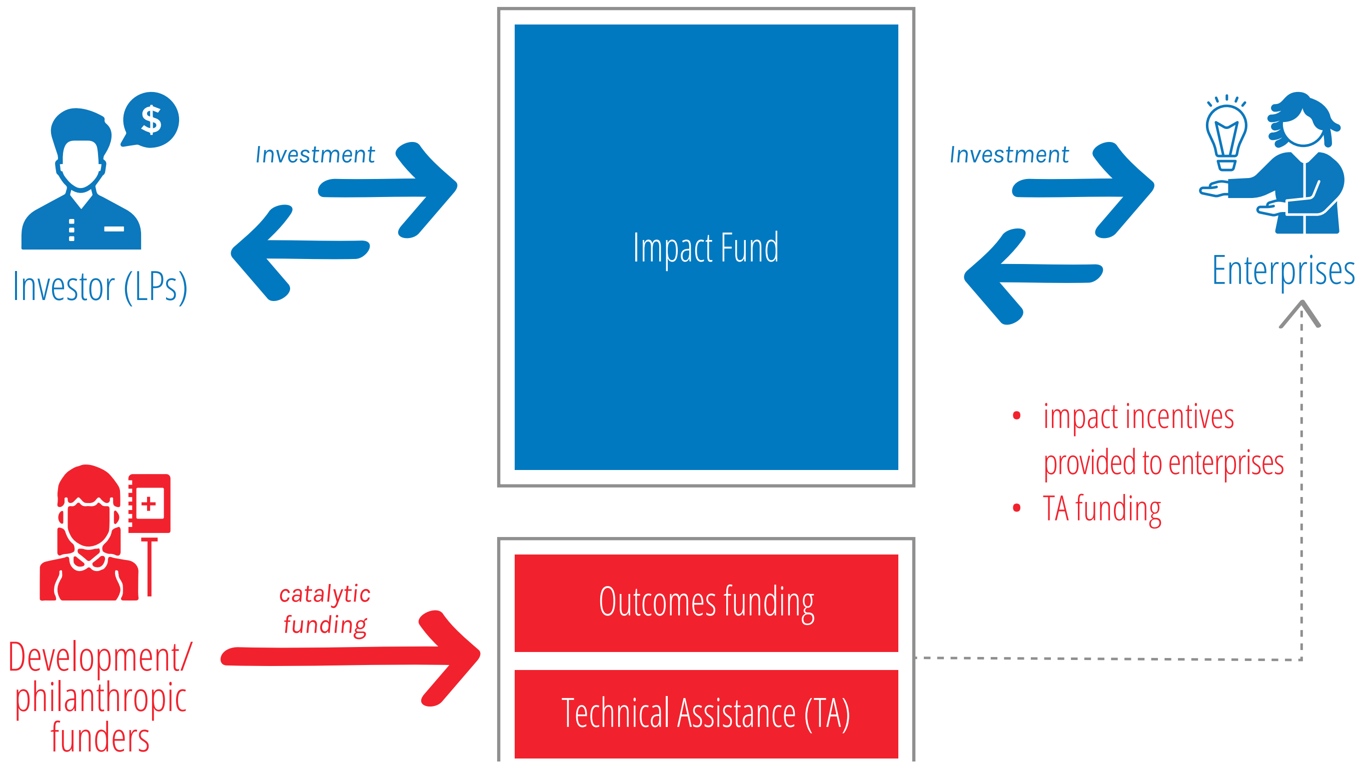
If the TA activity targets IMM system development for an enterprise, it's possible to even plug it into an ILF instrument. One example: *Impact-Ready Matching Funds (IRMF)*. Considering the high and increasing importance of having impact data and appropriate IMM capabilities, not only for Impact-Linked Finance but for impact-oriented investors more generally, we created this hybrid ILF instrument combining TA features for IMM system development with a matching fund mechanism (see table above "Impact-Linked Finance instruments for early-stage enterprises").

With IRMF, an enterprise is financially rewarded for achieving specific milestones related to developing a more robust IMM

BREAKING THE SILOS: USING TA GRANTS FOR IMPACT INCENTIVES

Technical Assistance (TA) is typically funded through grants. If we consider that many funders, particularly public actors such as Development Finance Institutions, do not have specific budgets for impact incentives yet, one key idea would be to leverage existing TA budgets to combine funding for capacity building with impact incentives.

Graph 16. Integrated TA and incentive funding



system that can sufficiently collect impact data more reliably and scalably. All the IRMF deliverables must meet minimum quality standards within a specified time frame before payments are released.

We believe in the double dividend of IMM: optimizing positive impact and enabling the enterprise to benefit from having important customer data for improved business decisions. However, many enterprises, despite receiving TA support, have not yet unleashed this potential. Consequently, they are not yet ready to receive ILF.

Recognizing this challenge, we began making it easier for enterprises to strengthen their IMM muscles and, in doing so, improve their chances of accessing Impact-Linked Finance. Through our *Social Finance Academy*, we offer targeted capacity building to Enterprise Support Organizations (ESOs) and their entrepreneur cohorts. This begins with *Train-the-Trainer* programs in IMM and Impact Investment Readiness (IIR), which can be combined with *Voucher Schemes*. After being trained and certified, ESO trainers then provide follow-on IMM and IIR support directly to entrepreneurs. In addition, our *Impact-Linked Finance Readiness Bootcamp* has proven to be very effective, as it specifically prepares enterprises for an ILF transaction.

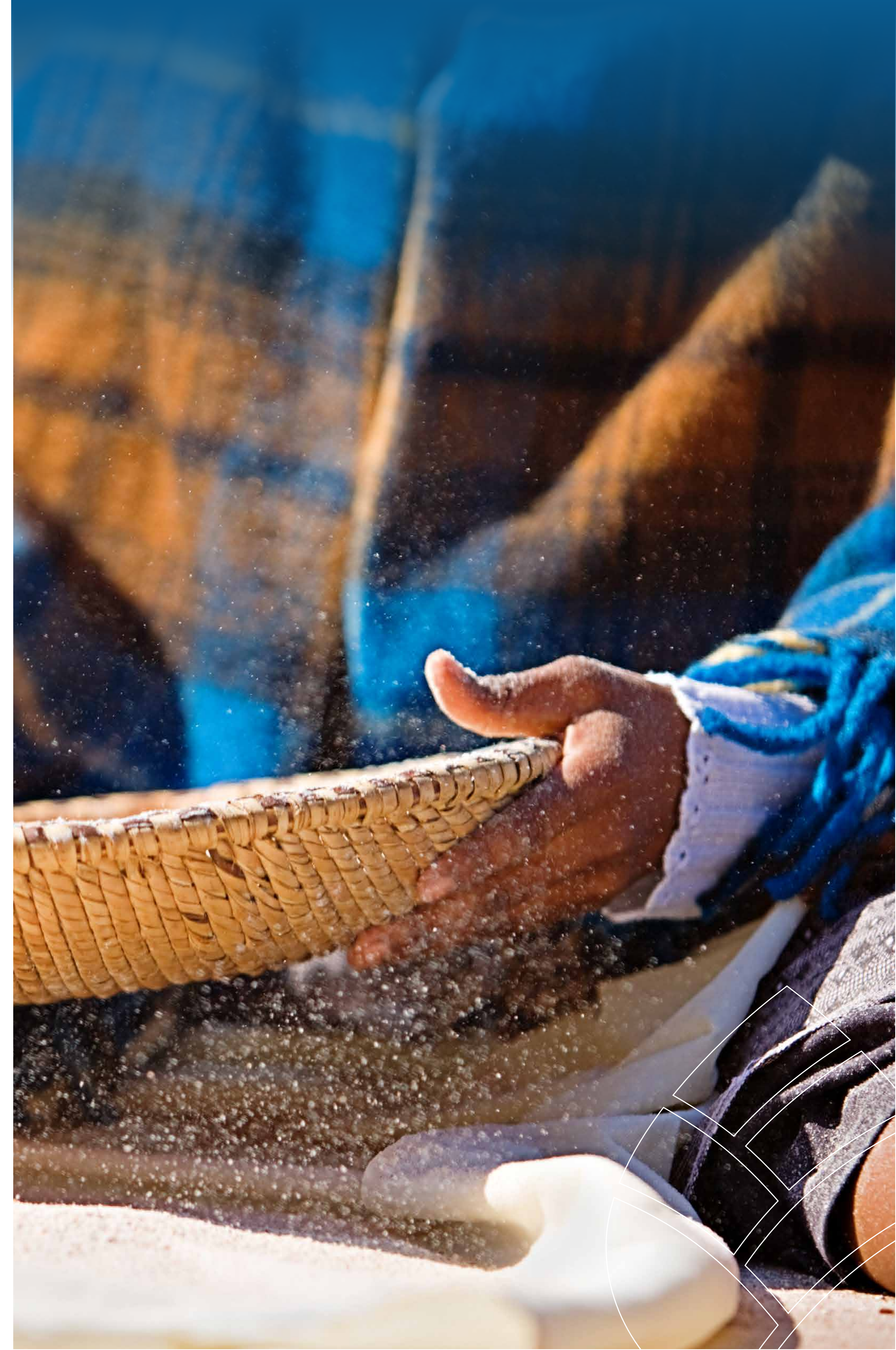
IMPACT-LINKED FINANCE READINESS BOOTCAMP

The Impact-Linked Finance Readiness Bootcamp aims to assist enterprises with identifying, analyzing, and addressing gaps in their IMM practices. The goal is to better prepare them for receiving financial incentives that are directly linked to their impact performance.

The learning outcomes aim at elevating current IMM systems so they can demonstrate additionality, establish sufficient and high-quality baseline data, and give key insights on impact variance. This way, commercial and impact performance, which are essential ingredients in any successful ILF transaction, can be optimized.

The Bootcamp is delivered through group workshops and tailored one-on-one mentoring sessions. It effectively combines peer exchange and individualized learning on specific challenges that entrepreneurs face.

Read this product brief about the capacity-building solutions by Social Finance Academy



DESIGNING IMPACT-LINKED FINANCE EFFECTIVELY

We strongly believe that execution makes all the difference. For that reason, it is not possible to simply conclude that ILF "works" or "doesn't work." Instead, it is the design itself that determines whether ILF is either more or less effective.

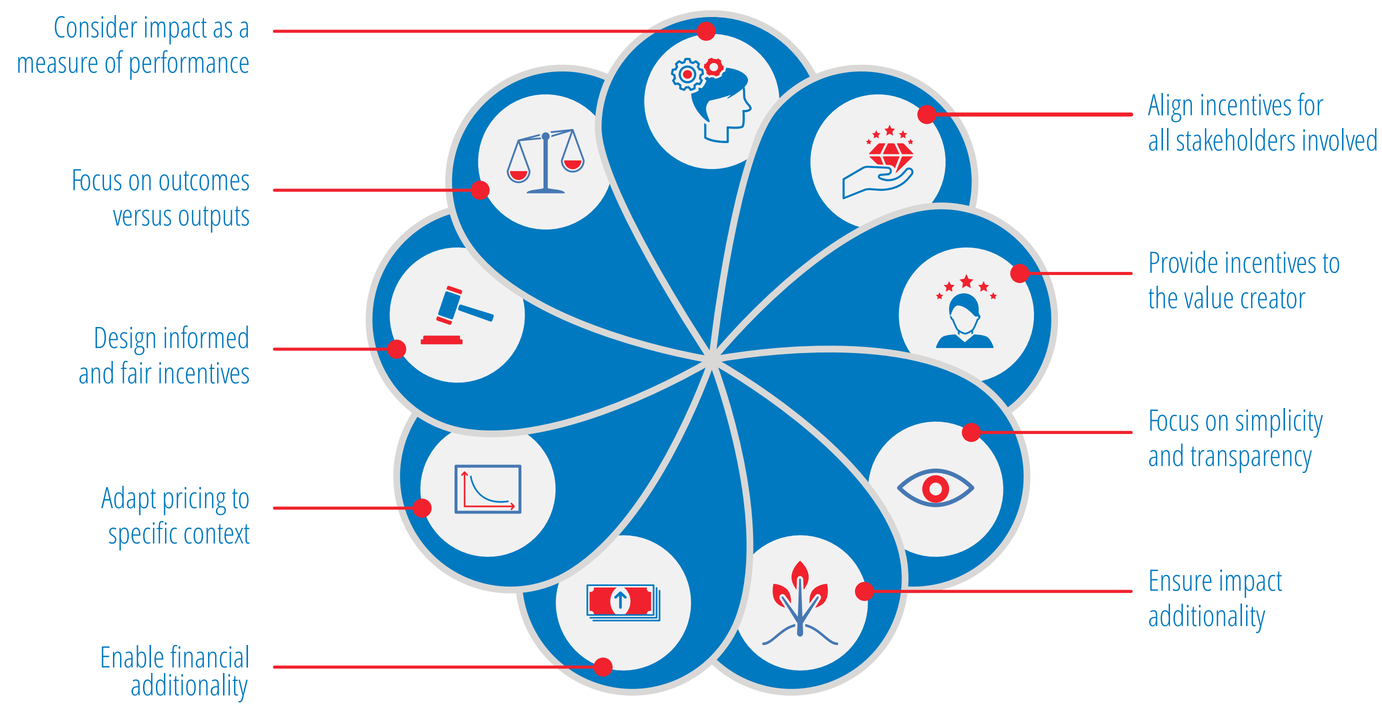
While our journey has been full of mistakes and lessons learned, these lessons led to the development of highly practical solutions, new features, and continuously updated design principles. The [Design Principles for Impact-Linked Finance]() continue to represent the most important benchmark for good market practice. These principles aim to outline how Impact-Linked Finance can be used most effectively while serving as a guide for other practitioners.

The ILF market is dynamic and there continue to be new practitioners who seek ways of applying what has already proven itself in practice. Hence, we have begun to create a simplified and open-source ILF (self-) assessment methodology based on the current Design Principles.

As the Impact-Linked Finance practice grows, we are fully aware that we are not in a position to define principles for the entire market, and that greater collaboration is both healthy and needed. Therefore, we are active supporters of a peer effort to ensure that these principles continue to flourish by being further developed and maintained from an independent body. At the time of writing, we were involved in preparations for the launch of an Impact-Linked Finance Collaborative. We are confident that this independent forum will soon take shape and further strengthen the entire ILF practice.

If you are interested in receiving additional resources, reach out to us or become part of our learning community.

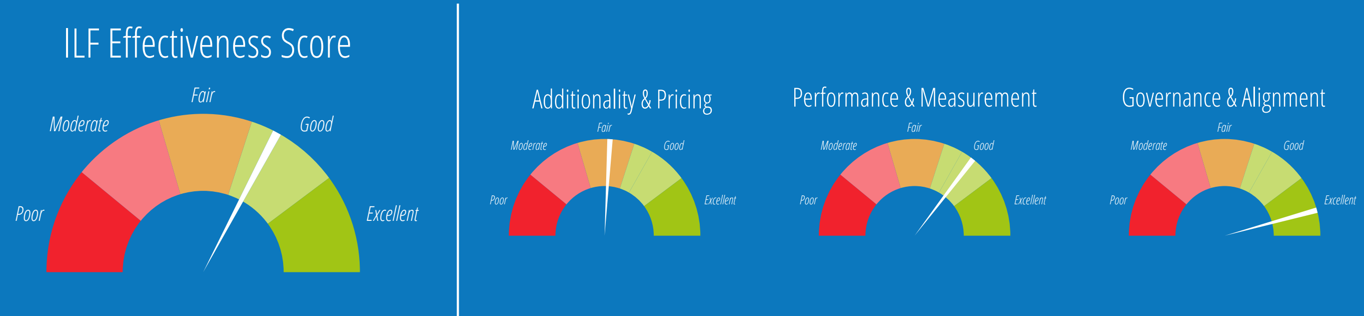
Graph 17. Design Principles for Impact-Linked Finance



MAKING QUALITY AND EFFECTIVENESS TANGIBLE: IMPACT-LINKED FINANCE (SELF-) ASSESSMENT

We have begun creating a simplified and open-source ILF assessment methodology based on the Design Principles for Impact-Linked Finance. ILF practitioners will soon be able to conduct their own assessment based on a questionnaire with predefined answers, resulting in an ILF self-assessment. Of course, this methodology is not a panacea able to sufficiently address all ILF-related challenges, as it must be developed further to cover all five ILF use cases. Nevertheless, we deem it an important step towards making terms such as "effectiveness" and "quality" more tangible and commonly understood.

Graph 18. Illustration of the ILF Effectiveness Score



The ILF Effectiveness Score indicates the extent to which the Design Principles for Impact-Linked Finance (ILF) are adhered to in order to support the most effective use of Impact-Linked Finance and provide guidance to practitioners on its application.

Assessment criteria according to Design Principles for Impact-Linked Finance (incl. weighting)

Additionality & Pricing (50%)	Performance & Measurement (25%)	Governance & Alignment (25%)
• *Impact additionality* • *Financial additionality* • *Context-specific pricing* • *Fair & Data-driven incentives*	• *Measure of performance* • *Outputs vs Outcomes* *Taking into account aspiration levels: basic, medium, superior*	• *Stakeholder alignment* • *Incentives to value creator* • *Simplicity & transparency*

1 BASELINE PROJECTIONS AND ADDITIONALITY ARE AT THE HEART OF EVERY ILF TRANSACTION

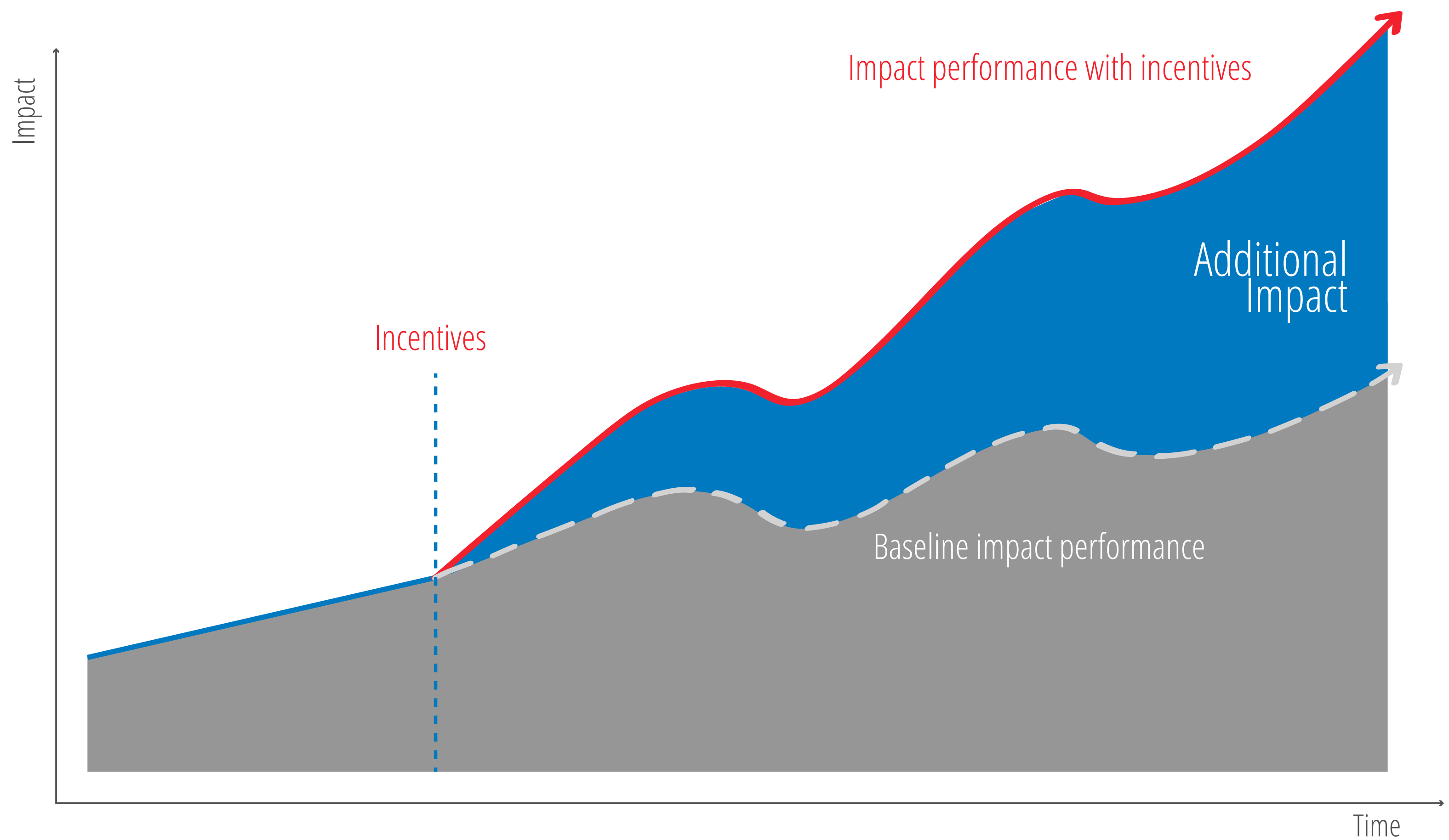
Without receiving Impact-Linked Finance, what would happen with an enterprise and its impact over time? This basic question is at the core of every ILF transaction. ILF is not about monetizing outcomes *per se*. Instead, what sets ILF apart from other practices entails rewarding outcomes that extend beyond baseline projections. Accordingly, ILF practitioners require a firm understanding of impact additionality, which is based on two well-informed scenarios: what happens to an enterprise with and without ILF support (also known as the baseline).

Drawing lessons from carbon finance shows how tricky it can be to assess additionality. In the Voluntary Carbon Market, in particular, an apparent lack of additionality regularly causes major doubts about implementation standards. In ILF, quality standards and integrity are crucial for the entire practice and specifically for defining additionality. After all, it's about whether an ILF transaction achieves good value for money.

One key rule of thumb: the more data available to define a baseline scenario, the better. An ILF practitioner should consider a variety of external influences upfront. For example, regulatory changes, market behavior, or new investors in the target enterprise can have both positive and negative effects on its future development.

In a few cases, we even had to factor in a deteriorating baseline to support the enterprise to stay on track. This clearly occurred during the pandemic, for example, but also in other cases, such as when a government introduced new subsidies or taxes that negatively affected the enterprise's targeted customer base.

Graph 19. Impact additionality generated through Impact-Linked Finance



We are fully aware that there is no perfect methodology to determine the precise level of expected impact additionality and probably never will be. However, this doesn't mean that it can't be projected in a sufficiently robust way. The key to this is having quality data upfront. Similar to any other simulation, the expected additionality is the result of a model that includes well-informed assumptions backed by robust data.

ILF is all about impact performance beyond what would have happened anyway. Once these additional outcomes are determined, they can be used to define appropriate pricing for rewards. We developed our own tools to support this process, which not only creates transparency for us, but also for the enterprise.

2 PRICING IMPACT INCENTIVES IS AN ART, SUPPORTED BY SCIENCE

While overpaying or over-discounting results can distort markets and decrease impact sustainability, paying too little to an enterprise for improved impact performance can reduce their motivation to achieve ambitious impact targets. Both do not represent good value for money, especially considering that each transaction includes transaction costs.

Importantly, the pricing of incentives should follow the well-established principle of *minimum concessionality*. This principle refers to the point at which an incentive does not distort the market but is instead sufficiently attractive to encourage and enable action. While appropriate pricing depends on the expected cost of creating additional impact, some cases are different: for example, when additional impact does not entail additional costs for the enterprise other than their initial (time) investment into making business changes. In this instance, we can encourage an enterprise with relatively low incentives to focus on a specific, underserved segment that *per se* is not less commercially viable than their current target segments. For example, this could include cases when financial services are targeting female customers.

HOW TO DRIVE DOWN IMPLEMENTATION COSTS

It is important to highlight that effective incentive design based on experience, know-how, and data is ultimately less expensive than an ineffective pricing of incentives. Put differently: there is a strong, positive correlation between implementation quality and value for money. However, standardized processes, digital tools, and clear methodologies offer potential to decrease transaction costs. As the ILF practice grows, we are committed to continue driving these efficiency gains.

Whenever calculating the initial and ongoing costs for an enterprise to deliver additional impact, we must consider that economies of scale and synergies usually cause unit costs to decrease over time. Eventually, this can reach a point where incentives may no longer be required, and impact can be created sustainably after the transaction ends. Because ILF focuses on incentivizing market-based organizations, it is possible to leverage their business operations to create additional impact in an efficient way and at a marginal cost. The more that impact objectives are aligned with the strategic direction of the enterprise, the fewer incentives are needed to push the boundaries.

We learned that, in some cases, incentives were even useful in addressing a perceived risk and busting myths. For example, if an enterprise initially assumes that serving a certain customer segment would be less profitable, an ILF transaction can prove that this may not be the case in reality.

To summarize, the following aspects must be considered when pricing impact incentives:

- Initial costs or investments by the enterprise
- Ongoing costs or lower margins, considering economies of scale
- Synergies with its ongoing operations and future strategy
- Perceived or actual commercial and impact risks

Handling these different aspects requires sensitivity, experience, and negotiation skills, which constitute the art of Impact-Linked Finance. In addition, it should be supported by science: corporate finance knowledge and calculation models for unit economics. Going forward, our models will continue to evolve to adequately cover the above dimensions.

3 LITTLE DATA IS BETTER THAN NO DATA, OR "WHAT IS GOOD ENOUGH?"

The biggest challenge for effective implementation of an ILF transaction is the availability of reliable impact data. So far, only a few of the enterprises we worked with had the necessary data available that would enable us to structure an ILF transaction quickly and easily. Instead, we became experts in answering the question "What is good enough?" and, through that process, we learned to design effective ILF transactions based on what we could immediately get.

In reality, we were simply responding to factors including market realities, transaction sizes, enterprise phases, and

Curious about this aspect? Read the case study of Clínicas del Azúcar

available budgets. As a result, we developed three ambition levels for designing incentive schemes: basic, medium, and superior. These three levels were then integrated into the *Design Principles for Impact-Linked Finance.*

At the basic level, when no or insufficient outcome data is available from the enterprise, it is still possible to structure an effective ILF transaction. However, this is only the case if there is sufficient evidence that the available output data demonstrates concrete and realistic expectations for outcomes. This approach can work in areas where the links between specific practices, outputs, and outcomes are proven and validated, for example, through academic research.

Table 3. Impact-Linked Finance aspiration levels

Source: Design Principles for Impact-Linked Finance

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 systems	*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*
Incentivize amount (relative to investment size)	*Lower* ⟷	⟷	*Higher*
Typical run-time	*Shorter*** ⟷	⟷	*Longer*
Transactions costs***	*Lower* ⟷	⟷	*Higher*

, **, * Detailed explanations can be found in the Design Principles for Impact-Linked Finance*

4 BASELINE CREATION AND (EVOLVING) IMM SYSTEMS CAN BE BUILT INTO ILF DESIGN

As the broader impact investing movement continues to grow, we are strong believers that impact data is not just useful for ILF. Indeed, any enterprise striving to learn more about the needs of their customers and the value-add of its products and services can find impact data to be strategically important. In that sense, being "ready" to receive ILF can bring a double dividend to the enterprise: receiving financial rewards for tangible, measurable impact and being able to better serve (more) customers.

Because many enterprises lack relevant impact data upfront, we made a virtue out of necessity by introducing a new, optional feature in ILF instruments with the so-called "IMM build-up phase." Instead of rewarding the achievement of specific outcomes immediately, the first year of an ILF transaction can be dedicated to the enterprise collecting baseline data and building a more robust IMM system. This process can be designed to include financial rewards. Then, from the second year onwards, once the IMM system is running smoothly, we can design and include incentives for specific outcomes that extend beyond baseline projections.

This IMM build-up phase is one of multiple optional features that we introduced based on learnings gathered over the past eight years. Each of these features can be incorporated according to the specific situation, which, in turn, makes ILF even more versatile and flexible to use.

Table 4. Overview of Impact-Linked Finance instruments and optional features

Products / Features	IMM build-up phase	Evolving metrics	Adaptive performance targets	Golden impact target (impact kicker)	Upfront payment (with repayment option)	Incentive repayment option	Conversion option
Impact-Ready Matching Fund	*Standard*				X		
Impact-Linked Challenge Fund	X			X	X	X	
Impact-Linked Matching Fund	X			X	X	X	
SIINC	X	X	X		X	X	X
Impact-Linked RSA	X	X	X	X	*Standard*	X	X
Impact-Linked SAFE	X	X	X	X	*Standard*	X	*Standard*
Impact-Linked Convertible	X	X	X	X	*Standard*	X	*Standard*
Impact-Linked Loan	X	X	X	X	*Standard*	X	X

DESCRIPTION OF OPTIONAL FEATURES

IMM BUILD-UP PHASE

- Initial rewards for achieving milestones related to build-up of IMM system and define baseline
- Subsequent rewards for impact performance (can be with evolving metrics)

EVOLVING METRICS (agreed from the start)

- Increasing (evolving) requirements for quality of impact metrics
- E.g. start with evidence-backed outputs that are then replaced by strong proxies and outcomes indicators over time

GOLDEN IMPACT TARGET (IMPACT KICKER)

- One ultimate impact objective to be achieved and rewarded
- May be combined with IMM build-up phase - starting with MoU; concrete agreement (with metrics and target level) to be made when the baseline and IMM system are in place

ADAPTIVE PERFORMANCE TARGETS

- Regular (e.g. annual) review of incentive schedules (metrics and target levels) and adjustment as needed (in agreement with the enterprise)
- Agreement on the schedule for periodic reviews from the outset

UPFRONT PAYMENT (WITH REPAYMENT OPTION)

- Any kind of payment upfront, that is repayable when impact targets or other conditions (e.g. investment raise) are not met

INCENTIVE REPAYMENT OPTION

- Agreement with the enterprise on (partial) repayment of rewards when certain triggers are reached (e.g. level of profitability, take over, ...)

CONVERSION OPTION

- Agreement with the enterprise on (partial) conversion of rewards provided into equity, debt, or any other form of finance when certain triggers are reached (e.g. level of profitability, qualified equity round, ...)

5 INCENTIVE SCHEMES MUST BE ADAPTIVE AS A RULE, NOT AN EXCEPTION

While all businesses must continuously adapt and respond to changing market needs, high-impact enterprises are particularly dynamic and responsive to their environments due to their high levels of innovativeness. Any decisions that impact-driven entrepreneurs make in their day-to-day business can cause a reduction or increase of impact levels, change in their type of impact, or even to the discovery of previously untapped impact potential. In some cases, rapid adaptation is essential for survival, as many entrepreneurs experienced during the COVID-19 pandemic.

Over the years, we learned that adaptability is crucial not only for the enterprises we support, but for their ILF incentive schemes as well. In the past few years, the pandemic was the main reason for adjustments to incentive schemes. Yet there were other triggers, such as new insights, including those coming from impact verification, as well as changing framework conditions, such as new regulations or technologies. For us, timely and deliberate adaptation proved to be the winning formula to help overcome these challenges and unleash an untapped impact potential.

This is why we now use adaptive performance targets as a standard feature in all ILF transactions. In practice, this means that we perform regular check-ins with enterprises to review their achievements to date and ambition levels, as well as their evolving market dynamics. In general, adjustments to ILF incentive schemes can always be made if there are compelling reasons for doing so. Of course, new targets still must represent good value for money.

6 IT IS STRATEGIC TO FOCUS ON RELATIVE CHANGE BUT ABSOLUTE NUMBERS ARE RELEVANT

Impact-Linked Finance is a powerful approach to support an enterprise in a strategic shift towards achieving greater impact. If an ILF transaction supports an enterprise to enter an underserved market or expand the offering to underserved target groups, this is a prime example of what ILF is capable of. An effective way to support strategic shifts involves agreeing on impact performance targets that are proportional in nature. For example, this could be the proportion of customers at the bottom of the pyramid or the proportion of customers within certain target geographies.

To achieve these changes, an enterprise is encouraged to innovate and plan strategically. It needs to lay the foundations for the future sustainability of specific business areas that promise to deliver greater impact. Agreeing only on the number of target customers will not support strategically shifting an enterprise's focus. However, absolute numbers hold important value. We have learned that it is wise to agree on both: a relative change, and a threshold for absolute numbers. For the latter, one can also use a multiplier for the incentive scheme based on numerical ranges over time.

The reason for this is that we must ensure that no rewards are provided for an enterprise making changes to only a very small number of beneficiaries. This would result in overpaying for the actual impact achieved. When planning and agreeing on targets, it is about striking the right balance between an appropriate diversification of the enterprise's overall commercial mix and the focus on specific ILF-targeted business areas or customer groups.

7 CASH INCENTIVES ARE (STILL) KING

At the core of Impact-Linked Finance lies the principle that impact incentives can be incorporated across the entire spectrum of finance. In most ILF instruments, these incentives are used to reduce the cost of capital for enterprises as a reward for creating exceptional, additional impact.

It seems counterintuitive that in some cases, separating the repayable capital from the impact incentives has proved to be more powerful than offering a combined ILF instrument. This is because the separation allows for a high degree of flexibility regarding the timing and amount of incentives being provided to the enterprise.

In an Impact-Linked Loan with regular amortization, for example, the absolute amount of interest decreases over time. This also applies to the absolute amount of rewards, as they are linked to the interest rate. This process does not always support the desired effect of the impact incentive. Instead, it typically takes extra time before significant additional impact can be achieved, which means that more, rather than fewer, incentives are needed in later phases of an Impact-Linked Loan.

We've identified two simple solutions to address this misalignment:

(1) Providing a regular loan and SIINC in parallel, which synchronizes the terms of both instruments. Instead of reduced interest rates, the enterprise then receives cash incentives from the SIINC. The effect on the enterprise is exactly the same: a reduction in the cost of capital. The SIINC part can be designed very flexibly and, for example, respond to the need for a higher incentive in a later phase of

the loan. Another advantage of this solution is that it does not require any adjustments to the credit systems, which are often not set up to process interest rate step-downs.

(2) Providing a zero-interest loan with agreement of a separate payment plan for the interest that is independent of the repayment of capital. We call this a "loan with sidecar." It allows for full flexibility regarding when and how much rewards are granted during the loan term.

8 SELECTION AND INCENTIVE DESIGN NEED TO CONSIDER SUSTAINABILITY AFTER THE "EXIT"

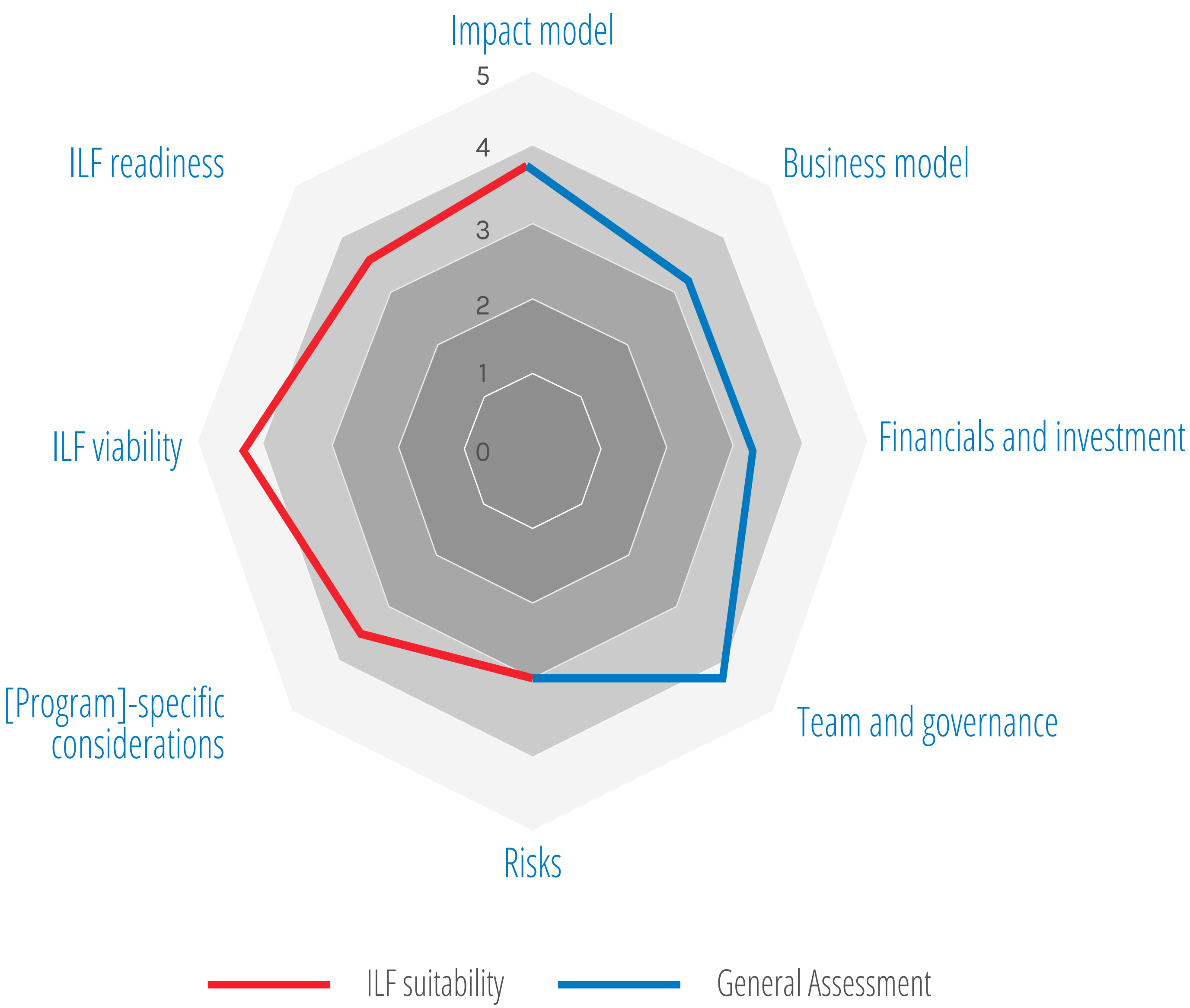
Although impact incentives are usually granted for a limited period, they should enable the company to maintain the increased level of impact after the transaction ends. Indeed, well-designed ILF interventions typically lead to improved impact performance that is strategic, sustainable, and embedded into the business model. This sets ILF apart from other approaches that generically monetize positive externalities.

Carbon credits, for example, are paid for an indefinite period (i.e. as long as the solution is in place), with the price being determined by the market. ILF not only follows a different approach, but also a different mindset: impact is never considered a uniform commodity like carbon. Instead, ILF harnesses the unique potential of each enterprise and incorporates its specific context into design and pricing considerations.

As described earlier, economies of scale and synergies usually lead to lower unit costs for an enterprise over time. Eventually, this can reach a point where the enterprise doesn't need incentives anymore and the (additional) impact becomes sustainable. A well-designed incentive system must take this into account.

Beyond incentive design, the selection of promising enterprises who receive ILF is paramount, as strong ILF candidates must show a high probability of creating sustainable impact after the "ILF exit." Practitioners should make this exit scenario a part of their enterprise selection process. We cover this requirement under the category "ILF viability," which is included in our selection scorecard. Concretely, we assess how long it will take the enterprise to create the impact sustainably, without further incentives, through economies of scale, technological leaps, or even public contracts.

Graph 20. Example enterprise selection scorecard



As always, there is no rule without exception: we have also seen cases where it is desirable to incentivize an enterprise over a much longer period and enable it to benefit underserved customer segments that are not suitable for fully market-based approaches. Such prolonged cases of incentivization could be justified when the total value created for society, or the positive externalities, exceed the cost of the ILF subsidy. Incentivizing high-impact enterprises through ILF can be an advantageous solution if the costs to do so are lower than the costs of the next best alternative to achieve the desired outcomes. In most cases, the best possible alternative is a non-profit or public intervention. Of course, the ideal funder for these specific cases that need subsidies over a long period should be domestic public funders through regular subsidy schemes (see page 20 *"The World Runs on Subsidies"*).

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A GLIMPSE INTO THE FUTURE:
INSPIRING IDEAS FOR COLLABORATION

A GLIMPSE INTO THE FUTURE: INSPIRING IDEAS FOR COLLABORATION

In the past eight years, we have confidently observed the significant potential of Impact-Linked Finance. Learning by doing has humbled us in the face of each enterprise's uniqueness as we seek to realize the full impact potential in each transaction. At the same time, these experiences have also fostered a long-term commitment to receiving feedback, driving successful execution, and never tiring of discovering better solutions.

Our inspiration not only stems from our talented team, but also from the entrepreneurs we support and their immense creativity to re-invent, re-iterate, be agile in the face of adversity, pivot, and sometimes literally emerge like a phoenix from the ashes. Empowering them to create additional impact for people and the planet, beyond business-as-usual, is what drives us each day to improve our work.

At Roots of Impact, we are committed to scaling this practice and continue building the field. And we strive to do this without diluting the quality of design and execution that, in our experience, ILF needs to be most effective. It is beyond exciting to see many practitioners beginning to embed impact incentives into finance in meaningful ways. We are only one of many pioneers, and there are innumerable opportunities to collaborate and materialize this potential together.

Here are just some of the ideas on how we can collectively use the momentum and push the boundaries of this practice:

- Every impact fund should have an impact incentive facility attached so that it can provide better terms for better impact.

- Impact incentives should become an integral part of any future technical assistance (TA). Funding for capacity-building activities is more powerful when complemented by funding for results.

- The time has come for Impact-Linked Funds for each Sustainable Development Goal - and for cross-cutting innovations. The targeted application of ILF with a strong focus on learning and improvement ensures that the emphasis is placed on truly additional and measurable results.

- With Impact-Linked Bonds (not to be confused with Impact Bonds), ILF can enter the capital markets. Large-scale Impact-Linked Loans that focus on the intersection of climate and gender can pave the way.

Our experience from supporting other organizations to launch their ILF practice taught us that we need more scalable solutions for a rapidly growing market. Right now, demand exceeds the capacity of qualified and experienced experts by far, and we are eager to take a big leap forward towards building the enabling infrastructure for scale.

After years of learning, experimenting, and refining ILF, we want to support others in growing this practice through continued peer-driven co-creation. This entails building a (virtual) place where a growing community of practitioners can meet, learn, discuss, evolve, and get inspired – and a digital platform for managing ILF transactions as easily as possible. In parallel to our focus on existing and new Impact-Linked Funds, we will build a platform that enables the ILF community to share knowledge, networks and experience and manage transactions in a scalable manner. There are many opportunities to fully realize the potential of Impact-Linked Finance and we are thrilled to collaborate with many new practitioners and partners in the years to come.

COMMUNITY OF PRACTICE

We're launching our Impact-Linked Finance Community of Practice at the end of 2024. Would you like to stay informed? Sign up for our newsletter.

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2024