Nudging the investment ecosystem by incentivizing impact

Opportunities in Incentivizing Impact in Financing Small and Growing Businesses in Developing & Emerging Markets
As a federally owned enterprise, GIZ supports the German Government in achieving its objectives in the field of international cooperation for sustainable development.

Published by:
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Programme/project description:
Sector Programme ‘Financial Systems Development’

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Photo credits/sources:
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GIZ is responsible for the content of this publication.

Eschborn, June 2018
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Acknowledgements

The authors would like to thank everyone who contributed to this discussion paper including the participants of the conference Financing Global Development – Leveraging Impact Investing for the SDGs hosted by the German Federal Ministry for Economic Cooperation and Development (BMZ) in Berlin on 21st November 2017, and particularly:

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The following issues emerged to be crucial for effective impact incentivization in investment:

» **Leadership matters:** Future innovations in impact management will be pioneered by organizations that apply smart incentives oriented towards internal change and impact alignment.

» **Transparency matters:** Future innovations in impact management will be nurtured by increased transparency along the investment chain.

» **Standardization matters:** Future innovations in impact management require a more common articulation of impact to help compare impact performance across investments and over time.

» **Technology matters:** Future innovations in impact management will likely build on emerging technologies such as big data, Blockchain and cryptocurrencies.

» **Markets matter:** Future innovations in impact management will likely build on market-based mechanisms that help to reward impact performance and hence ‘nudge’ the overall system.

This paper is only the beginning of a conversation. We invite interested organizations to build on the ideas laid out in this paper and connect for collective action to turn further ideas into reality.
This discussion paper builds on the results of the Conference Financing Global Development – Leveraging Impact Investing for the SDGs hosted by the German Federal Ministry for Economic Cooperation and Development (BMZ) in Berlin on 21st November 2017. The conference was part of a two-day event to which BMZ in cooperation with the OECD and supported by BMW Foundation had invited thought leaders and experts in the impact investing space. In the context of the German Presidency of the G20, the objective of the event was to create a forum for governments and international development agencies to connect with the impact investing community and to foster mutual learning and joint action towards financing the SDGs.

As part of the conference, Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH, Intellecap, and the Swiss Agency for Development and Cooperation facilitated a ‘design lab’ on the future of incentivizing impact in impact investing.

The hosts encouraged stakeholders from the impact investing ecosystem ranging from policy makers to fund managers and enterprises to imagine the future of impact measurement and management, specifically with the objective to maximize impact while channeling capital into small and growing businesses (SGBs). FMO, Vox Capital, and Roots of Impact shared good practices in incentivizing impact along the investment chain. Building on those insights, workshop participants developed new ideas on innovative instruments that could nudge the ecosystem towards actively pursuing and scaling impact.

This paper shares the findings of the session. It aims to foster a conversation around impact measurement and management 2.0 actively integrating impact incentivation in investment management. With this, it is to provide inspiration for both investors already pursuing impact investing strategies as well as those entering the field.

BACKGROUND

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With the 2030 Agenda, the international community adopted an ambitious and far-reaching framework for sustainable development. A core challenge in realizing the 2030 Agenda and its associated goals is the mobilization of additional financial resources. The UN estimates the global funding gap in SDG-relevant sectors to be USD 2.5 trillion annually. The Addis Ababa Action Agenda (AAAA), also adopted by the international community in 2015, provides a global policy framework for financing sustainable development. As such, it provides answers on how to support the implementation of the 2030 Agenda.

The AAAA highlights the need for additional private finance to complement limited domestic and international public resources for sustainable development. With the adoption of the SDGs and the AAAA, there has been an increased interest by the international community in developing innovative financing mechanisms aligning private capital with impact. The debate goes beyond the idea of mobilizing more capital, e.g. solely focusing on quantity. Rather, stakeholders across the spectrum realize the need to look at how to achieve better outcomes and impact, e.g. to more actively pursue and manage for quality. Impact Investing cannot only provide models for mobilizing private investments for the SDGs; importantly it provides frameworks for articulating, measuring, benchmarking and incentivizing impact.

Figure 1: Overview Sustainable Development Goals

4 Point 48, Section B (Domestic and International Private Business and Finance), AAAA Outcome, https://goo.gl/YYceKU
5 See for example Global Impact Investing Network (GIIN) IRIS framework, a catalog of general accepted impact performance metrics https://iris.thegiin.org/
Globally and particularly after the adoption of the 2030 Agenda, interest in impact investing has grown significantly. Governments have developed impact investing strategies (e.g. Brazil), have set up dedicated programs (e.g. DFID’s The Impact Program) or announced specialized units (e.g. Blackrock, Goldman Sachs). The spectrum of how much impact is engrained in each of those initiatives may differ. Nonetheless, current developments underline that impact investing has developed into a strategy witnessing increased participation by a diverse set of players who track their impact performance. Although the impact investing sector is still small compared to total global assets under management, GIIN’s member surveys underline its dynamic growth: The latest survey revealed that respondents collectively manage nearly USD 114 billion in impact assets – up from USD 77.4 billion the year before. While per definition all impact investors pursue measurable impact, more than 60% of surveyed investors reported that they also track their performance explicitly with respect to the SDGs or plan to do so soon. This is promising as successful impact funds and investments can inspire private investors along the whole spectrum – including those not yet actively pursuing and measuring impact – to integrate impact considerations into their investment strategies and channel funding towards the SDGs.

A few innovative private debt providers have started closing the capital gap providing venture debt and other mezzanine instruments.8

Effective impact measurement and management will help guide capital to impact-oriented SGBs. Tools such as IRIS, a catalogue of metrics to measure the social, environmental and financial performance of an investment, GIIRS, a rating system for impact driven funds and organizations, and PRISM, an impact and performance measurement tool that contextualizes impact articulation, have played important roles in shaping impact measurement and management practices. They provide a crucial basis not only for impact accountability but also for guiding capital and incentivizing impact.

Despite efforts, however, there is yet great untapped potential to incentivize actors along the investment chain to allocate funds to high impact SGBs and actively manage for impact. Due to reasons such as high perceived risk, disproportionate due diligence cost, lower potential returns, longer time horizons, and unfamiliarity with new business models in unknown markets, capital providers and fund managers are hesitant to place capital into SGBs. Further, once capital with an impact intention is placed, impact is at risk of being sidelined or the scale of impact achieved may fall short of its potential. This is due to mostly traditional incentive structures with a singular focus on financial performance that does not adequately integrate impact considerations.

While impact investing has gained momentum internationally, the amount of capital going into small and growing businesses (SGBs) as drivers of economic growth and social and environmental innovation is still marginal. Of the USD 200 trillion private equity funding available globally, only 1% is available through venture capital.7 Fund managers aiming to address the SGB funding gap struggle to raise the appropriate capital for investments in this sector. At the same time, many of the SGBs lack access to debt provided through traditional financial institutions due to a lack of collateral and other requirements that capital providers demand from their borrowers.

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7 75% of impact investors use PE instruments, 50% use debt (Source: GIIN 2017: Annual Impact Investor Survey)
The design challenge that needs to be addressed is hence to create incentives to maximize impact in investment strategies. Or to frame it into a question: How might we incentivize stakeholders along the investment chain — those who provide capital, those who manage it, and those who receive it — to channel their efforts towards high impact SGBs and to provide adequate support for scaling impact? There may be legal or structural mechanisms to ensure mission alignment; a variety of “carrots” and “sticks” can be applied along the investment chain. Impact-oriented remuneration, requirements for impact-reporting and monitoring, as well as pay-for-impact-schemes are just a few ways to incentivize impact. Others include incentivizing enterprises to keep pushing the boundaries to integrate impact in their business models instead of making impact an add-on.

The design question splits in two parts:

» How to incentivize the channeling of more capital into SGBs with innovative products, services and business models that serve the SDGs?

» How to incentivize the scaling of impact along the investment chain?

We asked around 50 stakeholders including fund managers, development finance institutions, intermediaries, enterprises, governments, civil society and other experts to come up with innovative ideas to address those issues. For inspiration, we looked at what is happening today in the area of impact incentivization.
Over the past few years, a mix of approaches have emerged to incentivize impact along the investment chain. In addition, data and technology providers have started to play an important role in providing the basis for impact incentivization. Given the rapid development of new technologies and efforts towards standardization of impact data, they will likely gain importance in the years to come as they open up a new range of possibilities. In brief, different actors along the investment chain face the following challenges that call for fresh thinking to incentivize impact:

» **Capital providers** often have competing logics within their institutions. In many cases, impact investments only constitute part of the portfolio and hence the institution is squeezed between competing objectives and organizational sub-cultures. As a result, many institutions go for tried and tested instruments and financing models. Knowledge and awareness about innovative structures that incentivize impact alongside financial performance is still low, resulting in a discomfort among capital providers to apply such models. In addition, capital providers often have a mix of internal stakeholders, whose incentives are not all aligned with impact creation. Also, the landscape of service providers and availability of information that can help develop and set up impact incentivization mechanisms is nascent, leaving capital providers without much guidance.

» **Fund managers and other financial intermediaries** often demonstrate ‘additionality’ in closing the capital gap for SGBs. They generate impact by catalyzing business model innovation, stimulating SGB growth, ensuring goods and services reach last mile markets, building entrepreneurial ecosystems, and driving employment and income. However, financial intermediaries often struggle to attract capital due to challenges related to the associated economics and risks of small-scale, early stage finance in developing and emerging markets and of serving lower- and middle-income customers. Transaction costs are perceived as being too high and markets as too unfamiliar. For that reason, capital providers often hesitate to put their capital into funds with an impact-orientation. Once invested in an enterprise, financial intermediaries may measure and report impact to capital providers. However, they may fall short of tapping impact potential if pushed for high financial returns and if not actively managing for impact.

» **Enterprises** serve low-income populations through innovative products, services and business models with essential goods and services. At the same time, they generate social and environmental impacts in the communities and markets they operate in. At the same time, impact enterprises often work in very challenging environments and market conditions, affecting their risk exposure and financial attractiveness to investors. As a result, they often face challenges in raising capital. Often finding themselves confronted with investors’ expectations to achieve the ‘big win’, enterprises may feel pressure to decrease risks and improve financial performance, thus losing sight of their impact objectives.

Impact measurement and management has seen increasing attention by impact investors over the past years. A dipstick review of the status quo of impact incentivization, however, indicates that the field is rather nascent and that there is significant potential to innovate (see Figure 2).


10 AT Kerney 2015: Scaling-Up the Social Enterprise. See https://www.atkearney.com/documents/10192/5487100/ScalingUp%20-%20Catalyzing%20the%20Social%20Enterprise.pdf/1f1a024a-a7a5-4763-873b-5087138467
Incentives to channel capital into impact

» Guarantees emerge as an instrument to incentivize capital providers to invest in impact

Guarantees as one form of credit enhancement has emerged as a widely used instrument within impact investing over the past years. As such it provides the potential to improve liquidity or unlock alternative sources of capital for impact enterprises. With one third of GIIN’s surveyed respondents having applied them in the 2017 reporting period, guarantees are a widely used instrument to incentivize capital providers to invest in impact.11 Governments or bi- and multi-lateral donor agencies play a critical role in developing guarantee and other de-risking mechanisms.12 13

11 GIIN: Annual Impact Investor Survey, 2017
12 Boost Africa is an example of a financing structure, where the European commission as an organization with a higher ability to take risk contributed through EUR 50 mn a junior tranche, absorbing risk of other investors and crowding in other forms of capital, for more see Boost Africa https://www.erdb.org/en/topics-and-sectors/initiatives-partnerships/boost-africa-empowering-young-african-entrepreneurs/
13 The European Investment Plan https://ec.europa.eu/europeaid/sites/deyo/files/factsheet-up-20171120_en.pdf is another example of a guarantee mechanism, aiming to attract additional capital specifically for investments in fragile countries in Africa

» Tax incentives to investors may help channel and scale impact

Tax relief schemes that incentivize mainstream investors to invest in small and medium enterprises offer a benchmark to learn from. Creating a specific impact investment tax relief mechanism could channel more capital into high impact SGBs and scale impact creation. Tax incentives have the potential to attract the appetite of high net-worth individuals into impact SGBs and can offer an alternative to existing instruments such as first loss guarantees.14 The UK Government has been experimenting with tax relief mechanisms for investments in social enterprises with the objective to increase their access to funding.15

14 For more on this subject of tax incentives, see Big Society Capital & The City of London 2013: The role of tax incentives in encouraging social investment, by Worthstone assisted by Wragge & Co LLP, see https://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2013/the-role-of-tax-incentives-in-encouraging-social-investment-Web-PDF.pdf
Impact performance-based revenue and payment of Impact enterprises (e.g., technical assistance, market linkages). This can be a powerful tool to incentivize fund managers to stay focused on impact and to channel funding towards innovative high-impact enterprises, new and untested business models, and business activities in difficult geographies. Alternatively, distribution mechanisms can be used to channel a percentage of the returns into the ecosystem in the form of grants once certain financial goals are met, e.g., to support intermediaries who can demonstrate the achievement of outcomes and ecosystem building activities.

Open Funds allow for longer time horizon for impact creation
As an alternative to closed funds that put fund managers under performance pressure within a set time period—often 5–7 years—open-ended funds have no time limit for fundraising or for when the fund must be liquidated. Thus open funds can allow for more patient investments as they are able to invest in enterprises for longer periods of time. This helps to avoid expectations for an unrealistic growth trajectory and selling stakes to an acquirer, who may not be aligned with the enterprise’s mission and impact orientation. An open-ended fund may maintain enterprises in the portfolio indefinitely, whereas the value is returned to investors in the form of dividends and appreciation. For the enterprises, this means less pressure to adapt the business model to the requirements of the investor which can enable the enterprise to stay on impact course.

Incentives to scale impact creation
Impact performance-based revenue and payment of impact premiums are on the rise
Some viable impact enterprises offer below market returns to investors and thus face challenges in attracting capital—or they are pushed towards a mission drift by more commercial, risk averse investors. To scale impact on the enterprise level, outcome funders such as governments, donors, or philanthropists have started to pay additional impact performance-based revenue to the enterprises on the basis of demonstrated, measurable impact. Through this mechanism impact enterprises get capitalized based on achieved outcomes, while simultaneously aligning enterprise and investor interests. Importantly, the additional revenue bolsters enterprises’ liquidity, provides working capital needed to scale, and increases attractiveness to investors by improving risk-return profiles. [see also Case Study 1]

Outcome-based funding in pay for performance schemes involve governments and donors
The past years have seen some degree of experimentation with results-based financing (RBF) and pay for success (PFS) instruments. Within such structures impact-focused payers such as philanthropic or governmental donors provide rewards and bonus payments to enterprises or intermediaries that demonstrate specific outcomes. Much attention has been put on the development of Social and Development Impact Bonds, with most experiments happening in developed markets, especially in the US and UK. However, an increasing number of mechanisms are being tested in the developing world. The field is still marginal while private debt and private equity are top instruments among impact investors. This is true especially in emerging markets where 90% of impact investors surveyed by GIIN deploy their capital via those instruments. According to the same survey, Pay-for-performance instruments are applied by hardly any investors in emerging markets and less than 1% of investors in developed markets.

Reimbursable grants with discounts based on impact creation are being tested
Borrowing the concept from innovation financing, and responding to the lack of traditional risk capital to finance innovative solutions, grants with discounts based on achieved impacts have become an innovative solution that is being tested by multiple organizations. The fund and enterprise agree on impact targets, after which the financier provides a reimbursable grant to the enterprise for an agreed period of time. The successful achievement of the agreed targets by the enterprise triggers discounts that can reduce the repayment of the reimbursable grant to zero.

17 For more information on this mechanism, see Social Impact Incentives http://www.roots-of-impact.org/siinc/ developed by Roots of Impact in collaboration with SDC 18 For an example from the Global South, see the efforts of Bertha Center on the Green Outcomes http://documents.worldbank.org/curated/en/222980150607470312/pdf/119912-BRI-climate-technology-program-in-brief-B-rg-outcome-based-financing-ra-pdf Fund, an outcome-based funding mechanism for SGMs, incentivizing local South African fund managers to increase investment in green SGB by paying for outcomes such as green jobs, climate mitigation, and improved water and waste management
19 For example, see Rockefeller Foundation Case Study of Social Success Notes, In: Transform Finance: Innovations in Financing Structures for Impact Enterprises: Spotlight on Latin America
20 GIIN Annual Impact Investor Survey, 2017
21 For more information on this see the example of the Multilateral Investment Fund, In: Transform Finance 2017: Innovations in Financing Structures for Impact Enterprises: Spotlight on Latin America
» Cultural shift makes impact creation aspirational within organizations
It requires a cultural shift that helps align leadership and staff with impact creation. This is true for capital providers, financial intermediaries, and enterprises alike. One main reason is that impact in investment or social business approaches is still often perceived as ‘non-serious’ and ‘not rigorous’ by many capital providers. To overcome this bias, actors along the investment chain have started to aim for cultural change within their organizations to make impact aspirational. Possible approaches include internal campaigns and aligning performance appraisal systems with impact [see also Case Study 2]. Also, clearly interpreting fiduciary duty – especially of large institutional investors – and underscoring the link of long-term wealth creation with social and environmental performance through education campaigns will help gearing awareness and action towards investing with impact.22

» Impact-based remuneration schemes are used to reward individuals
Capital providers and fund managers have experimented with impact-oriented remuneration models to connect compensation with impact performance.23 To validate the achievement of impact goals, funds may use established impact measurement and rating systems. Some funds have also established independent bodies such as an ‘Impact audit committee’ to judge whether goals have been met or not. A more short-term reward mechanism is an annual bonus based on the achievement of a pre-defined impact score. Such a score could comprise aspects like a fund manager’s engagement in the impact investing industry, the ability of its investment portfolio to achieve impact or the actual impacts achieved.24 In all cases, impact management systems, clear mechanisms for setting impact goals as well as key performance metrics and impact measurement are critical ingredients for such incentivization schemes. [see also Case Study 3]

» Protective provisions help to secure impact
Fund managers have started to protect the impact orientation of investments through protective provisions. To illustrate, funds may create classes of capital providers and give special rights to ‘impact-first investors’, meaning investors that prioritize impact over financial returns. Funds may also have a protective provision of requiring the consent of ‘impact-first investors’ in case of a deviation from or change of the mission. Some funds also consider an advisory board of capital providers to ensure staying on impact course and reserve the right to oversee mission and impact orientation. This is especially important for funds that are tapping into mainstream capital, e.g. from pension funds and other commercial capital providers.25

» Recoverable grants and convertible notes help to incentivize enterprises
Recoverable grants, soft-loans and convertible debt are instruments increasingly used to incentivize enterprises to ‘push the impact boundary’ and scale impact. This is particularly relevant for enterprises at seed and proof-of-concept stage that otherwise lack access to funding to grow their business. Some fund managers deploy a percentage of an overall fund portfolio, e.g. 10%, in the form of such ‘soft capital’ to meet the needs of unproven business models, while the remaining funds are disbursed in traditional loans. The advantage of this mechanism is that soft loans may attract capital from more commercial investors.26

A growing number of stakeholders have pioneered innovative approaches to re-imagine impact incentivization. At the heart of all these mechanisms lies impact measurement and management, with clearly defined metrics and targets. Currently most stakeholders along the impact chain apply their own mechanisms to articulate and measure impact; real comparability will come from more standardized metrics, measurement and reporting practices across the industry. There are additional questions around whether impact can be ‘tradable’ as we’ve seen in other fields: Mechanisms like Carbon Credits offer valuable lessons on how to ‘nudge’ the ecosystem towards standardization through a market- and incentive-based mechanism, instead of regulations. We invite stakeholders to think of ways to create market-based mechanisms to drive impact creation to the next level through smart incentives.

22 Wood, David 2013
23 An example for a similar structure is Areas Capital’s Africa Health Fund
24 An example of a fund with an Impact Audit Committee and Impact Score is Core Innovation Capital
26 The Multilateral Investment Fund is one example of a Reimbursable Innovation Grant, similarly, NESsT uses the instrument of Recoverable Grants as seed investments, see the case studies In: Transform Finance 2017: Innovations in Financing Structures for Impact Enterprises: Spotlight on Latin America
**Rationale:**
Market-driven solutions can be powerful in tackling social challenges. There is a number of enterprises that have started to address existing market gaps in low income segments and address social challenges with innovative market-based solutions and business models. However, those enterprises often face several barriers in starting and running their businesses in complex and adverse environments. It is not uncommon that they require more patience when it comes to revenue, profitability and return expectations. To address this issue, Social Impact Incentives (SIINC) aim to link impacts achieved with the profitability of such enterprises.

**Impact Incentive Mechanism:**
Social Impact Incentives (SIINC) reward high-impact enterprises with premium payments for their social performance. The additional revenues enable them to enter segments where the market fails, improve profitability and attract investment to scale. SIINC is a simple bilateral contract. It pays ongoing premiums directly to a revenue-generating enterprise – not to an intermediary or an investor. With stronger financial projections, enterprises are intended to immediately become more investable and able to attract the necessary capital for scale.

**Impact & Performance Assessment:**
SIINC builds on an individually-developed impact roadmap: it lays out a plan for the evolution of impact metrics to be tracked and independently verified. Those metrics are used as payment triggers over the course of the SIINC contract. The impact measurement doesn’t have to be overly complex or expensive. It draws on Acumen’s “Lean Data” approach as it seeks to hit the sweet spot at the intersection of useful business and impact metrics.

**Example:**
The first two SIINC transactions were finalised in 2017 in a project led by Roots of Impact in partnership with the Swiss Agency for Development and Cooperation (SDC), the Inter-American Development Bank (IDB), New Ventures and Ashoka. With SIINC, Clínicas del Azúcar in Mexico and Village Infrastructure Angels in Honduras were able to close funding rounds while pushing the limits of their impact models. Clínicas del Azúcar (CdA) operates a network of ‘one-stop-shops’ offering high-quality, cost-effective and specialized healthcare services to treat and prevent diabetes in Mexico. SIINC supported CdA in implementing an appropriate delivery model for reaching deeper into lower income populations. It rewards and incentivizes CdA to increase the penetration of their diabetes services to the base of the pyramid (BoP) population while maintaining high quality services. So far, CdA has reached more than 50,000 patients from various income groups with nine clinics. With a combination of 1.5 mn USD investment and up to 275,000 USD in SIINC payments over a period of 2.5 years, the enterprise now aims to expand its services all over Mexico.
CASE STUDY 2:
Creating a cultural shift – FMO

Rationale:
FMO, the Dutch development bank, has been financing the private sector in developing countries for more than 45 years. Through FMO’s focus on investing in countries’ financial, energy and agribusiness sectors, the bank aims to empower entrepreneurs by providing loans and guarantees, taking equity stakes and engaging in other investment promotion activities. In developing its 2025 strategy, FMO looked to align its strategic agenda with the SDGs with a particular focus on climate action (SDG 13), reduced inequalities (SDG 10) as well as decent work and economic growth (SDG 8). FMO is actively aligning to these impact focus areas across its investment departments, advancing the organization’s existing 2020 commitment to double impact in terms of jobs supported and to halve FMO’s footprint by doubling GHG emissions avoided.

Impact Incentive Mechanism:
In order to embed the increased focus on the three selected SDGs across a development bank of nearly 500 people, FMO runs a targeted change campaign. A range of instruments including storytelling and sharing of success stories is used to inspire staff: By sharing regular news updates, investing in and arranging visits to high-impact enterprises, as well as by providing information on current trends and conferences to employees, enthusiasm is being created within the larger organization.

FMO also adjusted its performance and appraisal system to reward impact: Performance targets are not only set on financial performance, but also with regard to investments according to impact labels. Those labels serve as a steering mechanism to increase the share of investments in FMO’s focus impact areas. FMO has adopted a ‘Reducing Inequalities label’ and a ‘Green label’ for measuring and tracking progress on SDGs 10 and 13. Investments that meet pre-defined inclusivity criteria such as investments in microfinance or smallholder finance or that target Least Developed Countries qualify for the Reducing Inequalities Label. Investments that involve climate mitigation, adaptation or otherwise footprint reducing characteristics such as renewable energy projects qualify for the Green Label. Furthermore, FMO established relevant checks and balances to help align impact goals with financial goals. This involves transparency and accountability mechanisms e.g. providing ex-ante disclosure of investments before contracting on the FMO website and actively involving civil society and other stakeholders in the public consultation on FMO’s Sustainability Policy.

Impact & Performance Assessment:
FMO’s broader targets are cascaded through a performance and appraisal system. A management dashboard tracks progress against impact metrics, alongside ESG and financial metrics. An ESG performance tracker and target were introduced to reinforce the focus on identifying priority risks and on improving outcomes. Tracking the ESG and impact performance of an investment on a regular basis enables FMO to identify priority impact risks and deploy or adjust resources accordingly. FMO also uses portfolio evaluations to further inform impact and ESG steering. These are publicly available, as part of FMO’s commitment to transparency and accountability.
CASE STUDY 3:
Compensating for Impact – Vox Capital

Rationale:
Vox Capital was established in 2009 when the term ‘impact investing’ had not been used widely yet. As a result, structures were needed that supported the new concept and that were aligned with the objective to generate both financial and social impact return. To underline its commitment to both aspects, Vox Capital developed a compensation mechanism. The mechanism aligns the interests of investors and fund manager, as there are two targets to be met through the investment made by the fund – financial and impact targets. On top of traditional financial metrics and benchmarks, investments have to be selected and managed to also achieve impact benchmarks. The impact intentionality has to be translated into objective results.27

Impact Incentive Mechanism:
In Private Equity and Venture Capital, returns achieved by a fund usually are divided between the capital providers and the fund manager. The compensation for the fund manager is referred to as ‘carry’. The capital providers normally keep 80% of what exceeds the financial benchmark and the fund manager receives 20%. Vox Capital used this structure and adapted the fund manager’s side: If only the financial target is met, Vox Capital receives 10% of carry; only if the financial target and the impact target are simultaneously met, the fund manager receives the full 20%.

Impact & Performance Assessment:
Vox Capital uses two ways of assessing the impact of its portfolio:

» Internal assessments: Vox Capital understands that it is important to be very specific regarding the definition of the impact strategy for each investee company. Thus, together with the entrepreneurs, Vox Capital develops a theory of change for each new investment and defines the specific Key Performance Indicators (KPIs) on both outcome and output levels, to be monitored throughout the investment’s life.

» Third Party assessments: A third party assessment has proven to be valuable as a neutral assessment from an outsider, especially with regard to defining the compensation tied to impact. Vox Capital has been using GIIRS for the past several years, in particular, the ‘Customers Impact Area’ to assess achieved impacts.

Example:
Assume a fund with a 10% hurdle rate (minimum rate that a fund expects to earn) and a 20% carry. When the fund makes a profit, it is first allocated so that each capital provider receives its cumulative IRR (Internal Rate of Return) of 10% on contributed and un-returned capital. Next, 80% of all remaining profit is allocated to the capital providers proportional to their respective capital commitments. 20% is allocated to the fund manager, if it reached not only the financial hurdle, but also the impact hurdle.

27 For more information, see case study by Daniel Izzo 2013: Aligning Interests in Impact Investing, Stanford Social Innovation Review, see https://ssir.org/articles/entry/aligning_interests_in_impact_investing

Figure 4: Vox Capital Incentive Alignment Model

50% of Vox Capital team carry is dependent on achieving impact metrics as assessed by GIIRS.

3rd party assessment by GIIRS for Impact Investing
Impact transparency as foundation for impact alignment - DEG

Rationale:
DEG, a subsidiary of KfW Banking Group, is the German development finance institution. DEG has provided private-sector enterprises operating in developing countries and emerging markets with long-term finance and technical assistance for over 55 years. Already in 2000, DEG developed the Corporate-Policy Project Rating (GPR), a steering, monitoring and reporting tool for development effectiveness. In 2016, DEG advanced its multidimensional index-based development assessment based on the experience with the GPR, guided by the SDGs and adopting internationally harmonized indicators (HIPSO). The resulting Development Effectiveness Rating (DERa)28 was adopted in 2017.

Impact Incentive Mechanism:
Development Effectiveness is one out of three strategic goals for DEG. The Development Effectiveness Rating (DERa) is used to steer and measure this goal and provides the foundation for benchmarking impact performance and for building more advanced incentivization mechanisms. With DERa, DEG steers on the actual (realized) development performance of its portfolio rather than only on impact intention. A DERa target score is set for the portfolio as a whole. Whether or not this target is achieved will affect the level of performance related bonuses. On individual client level, DEG compares the current impact performance to its potential when deciding to finance a client. At the time of signature the current performance can be lower than the target score as long as the expected contribution reaches the target score within the tenor. During portfolio management, DEG actively supports its clients to become better and thus improve the rating.

Impact & Performance Assessment:
DERa focuses on the impact and performance of private enterprises – corporates, project financiers, financial institutions and funds – that DEG provides with finance and advice. DERa is based on the Theory of Change as set out below and captures the effects on clients’ output and societal outcome level.

DERa is structured along five categories incl. three key private sector contributions to development: creating decent jobs (SDG 8), boosting local income, and developing markets and sectors through innovation (SDG 9). The remaining two categories – embedding environmental stewardship and community benefits – focus on how those effects were achieved by assessing the way of doing business (sustainability). DERa then produces a cumulative score with a maximum of 150 points. This score is linked to mainly quantitative and some qualitative indicators in the five categories. The tool is applied throughout the project cycle. The first DERa is created during the commitment phase for a potential client. It contains (a) current values before commitment as a baseline and (b) an ex-ante estimation of development effects with 5-year horizon. After approval and disbursement, the DERa for this client will be updated annually.

Specific Example:
Virú Group ("Virú") is one of the three biggest agricultural exporters in Peru. The company has a fully integrated business model including cultivation, processing and distribution of fresh, preserved and frozen vegetables and fruits, as well as value added products like pestos and ready-to-eat meals. The DERa review of Virú’s operations against critical metrics takes into account local contexts.29

29 The full case study is available online https://www.deginvest.de/International-financing/DEG/über-uns/Was-wir-bewirken/Wir-messen-Wirksamkeit/
### Figure 5: DERa / Virú Case Study Illustration

<table>
<thead>
<tr>
<th>IMPACT CATEGORY</th>
<th>INDICATORS/ASSESSMENT FIELDS</th>
<th>QUANTITATIVE CONTRIBUTION TO TOTAL DERa SCORE</th>
<th>CASE STUDIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Good, fair employment</td>
<td>• No. of jobs¹</td>
<td></td>
<td>• 19/19 for direct jobs</td>
</tr>
<tr>
<td></td>
<td>• % of employment</td>
<td></td>
<td>• 3/9 for job growth</td>
</tr>
<tr>
<td></td>
<td>• Indirect employment</td>
<td></td>
<td>• 9/9 for indirect job creation</td>
</tr>
<tr>
<td>Local Income</td>
<td>• Total local income²</td>
<td>75%</td>
<td>• 19/19 for local income level</td>
</tr>
<tr>
<td></td>
<td>• Annual % growth in incomes</td>
<td></td>
<td>• 16/19 for local income growth</td>
</tr>
<tr>
<td>Development of Markets and Sectors</td>
<td>• Focus on the LDCs, particularly development-relevant sectors³</td>
<td></td>
<td>• 0/13 for country &amp; sector</td>
</tr>
<tr>
<td></td>
<td>• Innovation support⁴</td>
<td></td>
<td>• 14/16 for innovation capacity &amp; market share enhancement</td>
</tr>
<tr>
<td>Environmentally compliant economic activities</td>
<td>• Environmentally sound management</td>
<td></td>
<td>• 17/25 on climate friendliness</td>
</tr>
<tr>
<td></td>
<td>• Positive climate and environmental effects</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Benefits for local communities</td>
<td>• Management of risks for local communities</td>
<td>25%</td>
<td>• 11/17 on management of community risks, grievance mechanisms, and develop-</td>
</tr>
<tr>
<td></td>
<td>• Active supporting of local communities</td>
<td></td>
<td>ment activities</td>
</tr>
</tbody>
</table>

1 - ILO Compliant weightage;  
2 - Weighted by GNI per capita & PPP;  
3 - IFC Performance Standards;  
4 - Climate & environment quota* - Contributions >20% to overall weightage  
as it accounts for environmental initiatives and activities at the community level.
Through a participatory design process more than 50 stakeholders from different backgrounds identified a number of innovative approaches and new ideas to incentivize impact. Those ideas offer a snapshot of the current thinking of ecosystem stakeholders around how the future of impact management could look like. Some of those ideas are already in the early stages development and a range of innovators have started to turn them into reality:

**IDEA 1: Online market places and impact auctioning**

Market places and auctioning mechanisms have been explored in other policy fields already, e.g. emission trading in the climate policy mix. The idea can also be applied to the impact investing space. For instance, a government player, a donor agency, or outcome funders could define and frame a challenge to which enterprises would bid with their solution. In a second stage, proposed solutions would be assessed and selected based on the quantified impact potential. Similarly, enterprises could ‘pitch’ their impact through an online marketplace and investors can filter and identify impacts in line with their investment strategy. Blockchain technology could facilitate the set-up of such a market place. The start-up “Alice”, for instance, is a social funding and impact management platform built on Blockchain: The impact performance of enterprises is made publicly available, allowing investors to identify enterprises that they feel meet their impact objectives. Through the sharing of impact data, due diligence costs and reporting costs are reduced while overall transparency is improved.30

**IDEA 2: Impact currency**

Associating a currency with impact enables individuals and consumers to ‘purchase’ impact. A number of experiments exist to use Blockchain technology and cryptocurrencies for setting up such mechanisms. For instance, the early stage start-up Impak Finance tests the suitability of Blockchain-based token sale and so called “impak coins” for impact investing: an impact scorecard shows an enterprise’s social impact and allows procurement and investments from impact-oriented investors. An independent governance body would set the price quarterly.31

**IDEA 3: Impact rewards**

A reward system could also monetize impact on client instead of on enterprise level. This mechanism would create a responsible ‘parallel’ impact economy and incentivize clients to more responsible purchasing decisions. For each purchase of an impact product or service, a client would receive loyalty points that may be used to purchase further such products and services. Start-ups like Happystry have started to develop Blockchain-based token-systems that appreciate clients for their responsible consumption and impact creation. Earned tokens can be used to purchase further impact products and services. Such a mechanism helps to guide clients on the impact of their consumer behaviour, incentivizes them for their impact-oriented behaviour and increases the demand for impact enterprises’ products and services.32

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30 See more on website of Alice [https://alice.si](https://alice.si)

31 See more on website of Impak Finance [https://mpk.impak.eco/en/](https://mpk.impak.eco/en/)

32 See more on website of Happystry [https://www.happystry.com/home](https://www.happystry.com/home)
Spotlight: What does Blockchain have to do with impact management?

Impact management is about accountability, transparency and trust. The need for reliable information around impact performance is increasing. At the same time, investors, governments, and others demand more accountability and transparency regarding impact performance. The creation of meaningful incentive structures relies on a foundation of reliable impact data. Currently, verification of impact-related data often relies on intermediaries that verify information.

Blockchain can offer a technology to improve trust in the quality of data – without a middleman or intermediary. Thus, Blockchain turns into a potential default technology to create a trust protocol, which essentially means increasing trust in the quality of data. To explain Blockchain in simple terms, imagine every coin in your wallet was a person that you can interact with to find out its history and past. This is what Blockchain does: The whole history of our currency is hosted by a database of thousands of actors who can verify its quality. This is why Blockchain is also being referred to as ‘distributed ledger’ technology.

Blockchain finds use cases where trust and consensus come into play. Until recently, Blockchain was mostly discussed in the context of recording financial information of a company using the system explained above. However, Blockchain also allows to capture and exchange values or assets previously impossible to capture and exchange such as social impact: Blockchain-enabled technology provides an alternative to verify data and establish trust, accountability and transparency. It enables a system of shared infrastructure that could provide large-scale data sets on the social impact of interventions.

A shared infrastructure to record impact data would drive more consistency and standardization of impact measurement. In the future, even measurement itself could be decentralized and democratized due to the decentralized nature of Blockchain. In order to drive quality of data collection and measurement, incentivization can come into play: Those who collect and provide data could benefit from positive incentives. Tokens could be used as a reward mechanism.

![Blockchain transaction diagram](image_url)
IDEA 4: Impact indices
Rankings and benchmarks have been an effective way to incentivize organizations to ‘do better’ in various fields and encourage them to improve their performance. Building on this experience, an impact index could rank enterprises and investors according to their impact performance. Such a ranking could be based on actual performance using standardized metrics or on standardized and benchmarked survey results, e.g. with investees providing feedback on the value-add of their investors. A benchmarking would incentivize ranked stakeholders to compete for a better position within the ranking. At the same time, it would work towards standardized forms of articulating impact.

IDEA 5: Give-back distribution to support the impact ecosystem
To scale impact and strengthen the pipeline of investible impact enterprises, a fund manager’s profits could be re-invested into the ecosystem. World Tokenomic Forum, a social-enterprise think tank and consortium, recently launched such a mechanism: It created a fund model with a tiered give-back distribution of between 20 to 40% of impact fund’s carried interest profits. Profits are re-invested e.g. into non-profit organizations supporting next-generation entrepreneurs, global start-up ecosystems, impact enterprises, research organizations and incubators. Due to its strong focus on impact over profit, such an approach is particularly interesting for impact-first investors.

33 See as an example the Keystone Accountability “What investees think” https://keystoneaccountability.org/wp-content/uploads/2013/03/what-investees-think.pdf impact investor performance survey that used a common survey to collect feedback from 330 investees. Results were benchmarked across investors.

**Rationale:**
Intellecap, with the help of GIZ, IFC, and Shell Foundation has developed the impact measurement and management tool PRISM to help funds and enterprises to articulate impact based on the development context. It does so by leveraging a geography and impact data engine. The tool is currently under development to be integrated in outcome-based financing structures and to deliver ‘impact credits’ based on contextualized development impact.

**Impact Incentive Mechanism:**
PRISM’s geography-linked impact assessment tool developed for India, Kenya, Uganda and Rwanda allows the assessment of an investment’s impact potential based on the geographical context and sector-specific development metrics on regional or district level. PRISM Impact Certificates could be used to incentivize investors to channel capital into high impact geographies that are often also home to high risk enterprises. This would be achieved through additional context- and impact-based payments made by outcome funders such as foundations or development agencies to the investor.

**Impact & Performance Assessment:**
The impact and performance assessment and verification would happen through the PRISM tool and a combination of online and offline assessment. The geographical impact assessment tool to provide contextualized information on the region- or district-level developmental needs and impact potential is based on data from government or other official sources (e.g. World Bank, UN). The tool allows the assessment of investments as very high, high, medium and low impact potential. Referring to that assessment it allows the creation of impact certificates with different impact ratings. On that basis, the additional payment to investors is made, rewarding them for the impact created by the enterprise they are invested in.

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**Figure 6: PRISM Impact Certificates**

LOAN USD 100

PRINCIPAL USD 100

IMPACT ENTERPRISE

INVESTOR

ADDITIONAL PAYMENT OF IMPACT USD 10 – USD 20 DEPENDING ON CONTEXTUAL IMPACT

PRISM IMPACT CERTIFICATE

Confirmation of impact based on contextual impact potential following online & offline approach

IMPACT POTENTIAL

<table>
<thead>
<tr>
<th>Color</th>
<th>Impact Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maroon</td>
<td>Very High</td>
</tr>
<tr>
<td>Red</td>
<td>High</td>
</tr>
<tr>
<td>Yellow</td>
<td>Medium</td>
</tr>
<tr>
<td>Green</td>
<td>Low</td>
</tr>
<tr>
<td>White</td>
<td>Data Unavailable</td>
</tr>
</tbody>
</table>

PRISM geography impact assessment tool assesses which regions & districts need most development. It provides sector-specific assessment of impact potential based on government & official sources.
TRENDS SHAPING THE FUTURE OF IMPACT INCENTIVATION

The following issues emerged to be crucial for effective impact incentivization in investment:

1. **Leadership matters**: Future innovations in impact management will be pioneered by organizations that apply smart incentives oriented towards internal change. Leadership and organizational culture are crucial to align the internal ecosystems with impact.

2. **Transparency matters**: Future innovations in impact management will be nurtured by increased transparency along the investment chain including at government, capital provider, fund manager and enterprise levels.35

3. **Standardization matters**: Future innovations in impact management – no matter if market places, auctions or rankings – require a more common articulation of impact. Working towards a more common language forms the basis for better mutual understanding and enables effective impact benchmarking.

4. **Technology matters**: Future innovations in impact management will likely build on emerging technologies such as big data, Blockchain and cryptocurrencies that can act as enablers for innovative incentivization approaches. The characteristics inherent to those technologies respond to the need for lean, transparent, and peer-to-peer mechanisms with the potential to increase effectiveness and efficiency.

5. **Markets matter**: Future innovations in impact management will likely be built on market-based mechanisms that help reward impact performance and hence ‘nudge’ the overall system towards more impact orientation. Regulators and policy makers will play an important role to create relevant framework conditions.

The outlook for more impact capital and more active impact management in investment strategies is promising: Stakeholders’ views across the spectrum – from government and policy makers to capital providers, financial intermediaries and enterprises – converge around the idea that impact needs to be further engrained in investment strategies. With the adoption of the SDGs and the Addis Ababa Action Agenda the voices for not only providing more capital but also making sure to achieve better impact are becoming louder. This discussion paper shows that there is a number of mechanisms to incentivize impact already in place and several new ideas in the pipeline. This is true for the impact investing space focusing on small and growing businesses; importantly, this is also true for the broader debate on capital allocation for sustainable development. As outlined above and no matter if government, development agency, capital provider, fund manager or enterprise – each stakeholder group has ideas and instruments already at their disposal to direct more capital towards impact and actively scale impact.

This paper is only the beginning of a conversation: We invite interested organizations to build on the ideas laid out in this paper and connect for collective action to turn further ideas into reality.

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LITERATURE


KFW DEG, 2018. DEG evaluation results: Development effects of a Peruvian agriculture company and how DEG’s new Development Effectiveness Rating (DERa) captures these effects. [https://www.deginvest.de/DEG-Documents-in-English/About-us/What-is-our-impact/EN_Case-Study_Viru_2018_final.pdf](https://www.deginvest.de/DEG-Documents-in-English/About-us/What-is-our-impact/EN_Case-Study_Viru_2018_final.pdf) Published 2018


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