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**Swiss Agency for Development
and Cooperation SDC**

Impact-Linked Finance Fund (ILFF): Pooling Resources and Incentivising Impact at Scale

Case study

Snapshot

This case study is about the Impact-Linked Finance Fund (ILFF), a funding mechanism that pools and manages impact-linked finance (ILF) resources and builds the nascent ILF eco-system. ILF refers to a growing portfolio of financing solutions for high-impact market-based organisations that directly link financial rewards to the achievement of positive social outcomes.

Background

It is often more difficult for Social and Impact Enterprises (SIEs) to attract the investment capital they need to scale and deepen their effect as impact strategies are typically not being financially rewarded by markets – especially in early stages of their development. Interest in ILF has increased given more evidence about promising results of initial pilots, calling for an effective mechanism to pool ILF resources, deploy capital effectively, and shape the emerging ILF eco-system.

Format

In 2020, the ILFF has been set up as a Dutch Foundation that pools resources from public and private funders in thematic or geographical funding windows and works with a range of partners for the effective deployment of resources. The ILFF applies the range of ILF mechanisms that link financial terms to realized outcomes. In addition to the funding windows, the Fund offers an open platform as well as a knowledge and community building hub.

Benefits/Insights

The Fund allows for fundraising and deploying ILF capital at scale. It offers professional fund management services that enable the Fund to realise thematic and geographical synergies, to react flexibly to changing circumstances, and to achieve lower transaction costs compared to smaller one-by-one transactions funded directly by donors. In addition, the ILFF contributes to learning, field building, and standardisation of financing practices. The Fund uses a wide range of existing ILF instruments across sectors, geographies, investment instruments, and types of investors and investees. It is also likely to experiment with new ones in the future. The initiative has attracted significant interest and substantial financial commitment from both public and private funders. The Fund has also started to collect data to contribute to the international debate on standardisation in ILF and to share the learnings from pilot ILF programmes. Current insights on ILF mechanisms as applied by the Fund relate to target setting, pricing, and partnership strategies.

Outlook

The work of the Fund will be shaped by several trends and factors, including the increased availability of evidence and data, the use of digital tools and effective self (or user) reporting, an increased willingness to experiment with the full range of ILF solutions, to learn from these experiments and to share findings, and a rapid expansion to a wider range of actors in the social, private and public sector including traditional start-ups SMEs, corporations, and financial institutions.

1. Context

The Impact-Linked Finance Fund (ILFF) pools grant funding and provides finance that incentivizes market-based organisations to achieve additional positive outcome by using a variety of impact-linked finance (ILF) instruments. As such, the ILFF represents a complement and a shift from existing development approaches in at least two important ways:

- From providing project support to individual organisations to co-funding specialized financial intermediaries that pool and blend funding from a variety of public, private, and social sector funders and manage these funds in an independent, professional, and flexible way.

- From funding the full cost of projects and organisations to providing market-based incentives to shift behaviour of incentivized organisations and to attracting additional private capital towards more impact.

2. Challenge

Social and Impact Enterprises (SIEs) make a valuable and unique contribution to delivering essential goods and services to low-income communities and to addressing societal challenges. However, these organisations are often not financially rewarded adequately by the market for the impact they deliver. Together with higher (perceived or actual) risks and longer break-even times, it is difficult for such enterprises to attract the investment capital they need to scale and deepen their impact – especially during the critical early stages of their entrepreneurial lifecycle.

Innovative financial instruments such as Social Impact Incentives (SIINC, see Case Study) that reward SIEs for the impact they generate have been developed and successfully tested. Over the past years, the original SIINC pilots inspired the conceptualisation of a variety of ILF programmes that take different context as well as the needs and preferences of a broader variety of fundraising entities, investors, and lenders into account.

Still, despite increasing evidence for impact of the ILF concept, the field faces considerable constraints:

- **Awareness**
  Potential ILF funders still lack more information about benefits, mechanisms, and experiences of existing ILF programmes in different geographies worldwide.
- **Regulations**
  In some countries, regulatory provisions disincentivize or prevent public and philanthropic grant-makers to fund market-based organisations.
- **Silos**
  As private investors sometimes shy away from engaging in financing solutions that involve the public sector, there is a need for an independent intermediary that effectively brings different sources of capital together.
- **Capacity**
  Globally, few intermediaries have the capacity and skills to effectively plan, structure, and evaluate ILF deals and support the collection, measurement, and management of impact data.
- **Data**
  There is often a lack of data on target beneficiaries and related economics in different context to design effective incentive structures as required in ILF.

In 2020, the ILFF has been set up by Roots of Impact and iGravity, two reputable impact-finance pioneers to overcome above challenges and to bring ILF to its full potential.

3. Format

Objectives

In 2020, the ILFF has been set up with four complementary objectives:

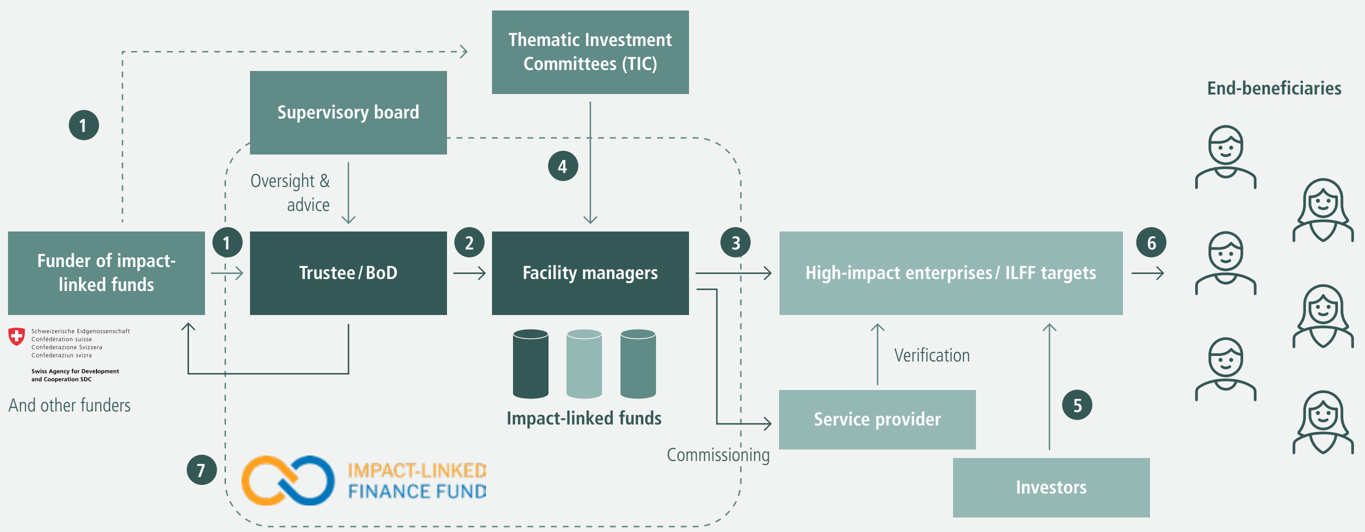
- To facilitate the pooling of capital and harmonise funding strategies by different grant makers.
- To reduce transaction costs and realise synergies between investees in a similar sector or geography.
- To offer professional, independent, and efficient fund management services.
- To help build the field of ILF by sharing knowledge, enhancing the capacities of funders, investors and intermediaries, and developing standards.

Institutional set up

The ILFF has been set up as a foundation ("Stichting") under Dutch Law by the German and Swiss impact firms Roots of Impact and iGravity. The ILFF team is governed by a Board of Directors (BoD), the executive team in charge for operational and financial management of the foundation. The BoD represents the Fund towards third parties and appoints the members of the Thematic Investment Committee. The Supervisory Board constituted by internationally recognised impact-finance experts provides on the one hand strategic advice to the BoD on the future direction of ILFF and the principles of ILF. On the other hand it supervises the policies and operations of the board. Furthermore, it shall promote the ILFF and facilitate networking with key strategic partners and potential funders.

The ILFF provides for different thematic or geographical funding windows ("impact-linked funds"). Each fund is structured differently and managed separately by a facility manager appointed by the BoD. The facility manager is responsible for the implementation of the transactions under each impact-linked fund. For each fund, a Thematic Investment Committee (TIC) is formed to oversee the fund's investment strategy and to advise on individual transactions. The TIC is made up of representatives from funding organizations, the facility manager, and one board member of the ILFF (Figure 1).

Figure 1. Exemplary governance and resources flow of the ILFF
Source: Based on material by Roots of Impact



1. **Funder** enters into a formal agreement with ILFF as **trustee** of the funds, and has the right to be represented in the **TIC**. | 2. The ILFF appoints **facility managers** for each the of the impact-linked funds, each of which have a different set up and structure. | 3. The **facility manager** structures the terms of the collaboration with selected **impact enterprises / ILFF targets** incl. impact deliverables and payment schedules. | 4. The details of the transaction are approved by the **TIC**, payments are made to impact enterprises and to service providers involved in the verification of outcomes. | 5. In case of SIINCs: Impact enterprises raise investment from **investors**. | 6. **Impact enterprises** use impact-linked funds to scale and deepen impact activities and are rewarded for achieving results. | 7. The ILFF is responsible for reporting financial flows and results to the **funders**.

As part of its field building mission, the ILFF offers an Open Platform on Impact-Linked Finance which serves as a knowledge, resource, and community building hub. Its aim is to offer tools, templates, tutorials, and best practice publications that are open-source and free of charge.[1] Other field building activities will be added as the Fund develops.

Impact-linked funds

For each impact-linked fund, specific investment guidelines are elaborated jointly with the funders which determine inter alia the investment strategy and criteria as well as the impact-linked finance instruments to be used. Impact-linked funds that use SIINC (see separate case study) have a requirement that (grant) payments need to be matched by additional private investment capital. The required leverage ratio depends on the specific context, region, sector and enterprise. The funding windows launched or under preparation so far with financial contribution by SDC include:

Impact-Linked Fund for Education (ILF for Education)

This Fund provides suitable ILF instruments to high-impact organisations offering inclusive and equitable education for vulnerable children and youth in the MENA region and West Africa. In addition, a substantial amount of the fund's target volume is reserved for technical assistance, research, and advocacy measures.

Impact-Linked Fund for Eastern and Southern Africa (ILF for ESA)

ILF ESA maintains and safeguards the results of SIEs in view of the on-going and post COVID-19 environment. The target sectors are health (including nutrition and basic services), WASH (Water, Sanitation and Hygiene), sustainable agriculture and food security, and income and employment with a specific focus on benefits to female-headed households in the region.

Impact-Linked Fund for Gender-Inclusive Fintech (ILF for GIF)

The Fund provides targeted ILF incentives and technical support to fintech companies that either already address gender-inequality to maintain and increase their outreach (scaling impact) or that are willing to reorient their products and services to explicitly address the needs of (migrant) women (deepening impact) in Africa, the Middle East, or Asia. ILF for GIF will also partner with eco-system enablers (accelerators, incubators, universities etc.) and fund managers to incentivise them to help identify and select suitable fintech companies (see Figure 2).

In phase 3 of the project, it is expected that the ILF for GIF will be set up as a blended-finance fund managed by an external fund manager in order to mobilise private sector capital and mitigate risks more effectively (Figure 3).

[1] The Open Platform is accessible here.

Figure 2. Impact-Linked Fund for Gender-Inclusive Fintech (ILF for GIF) (phase 1 and 2)
Source: Based on Roots of Impact

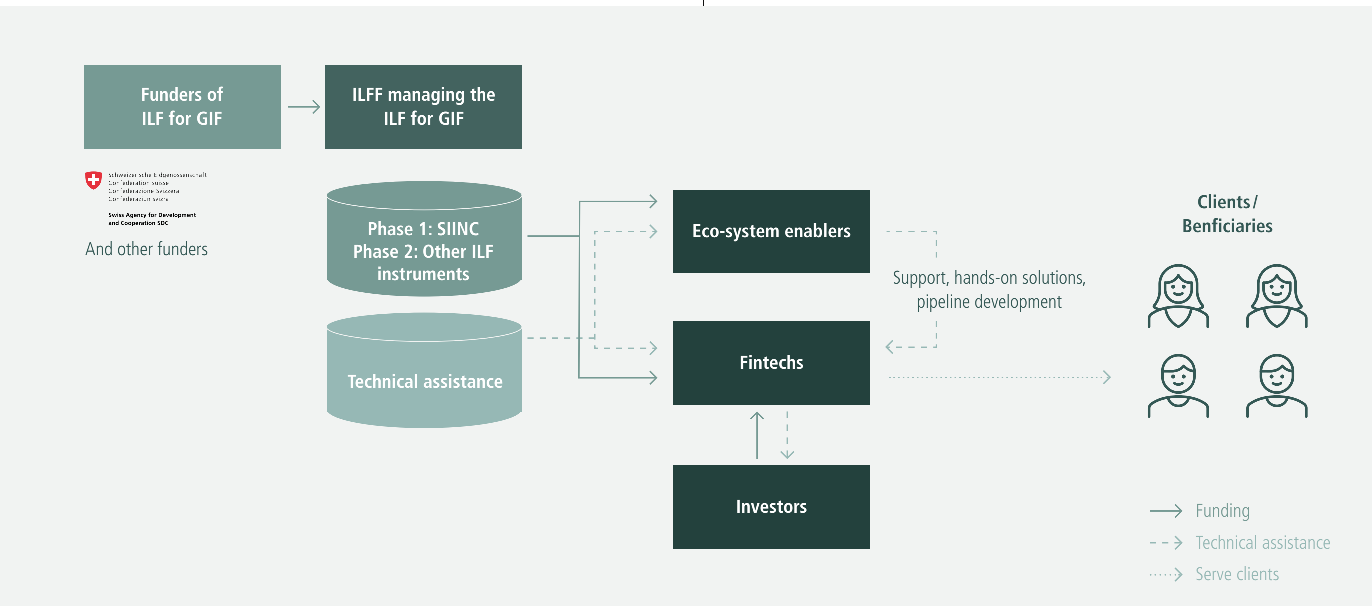
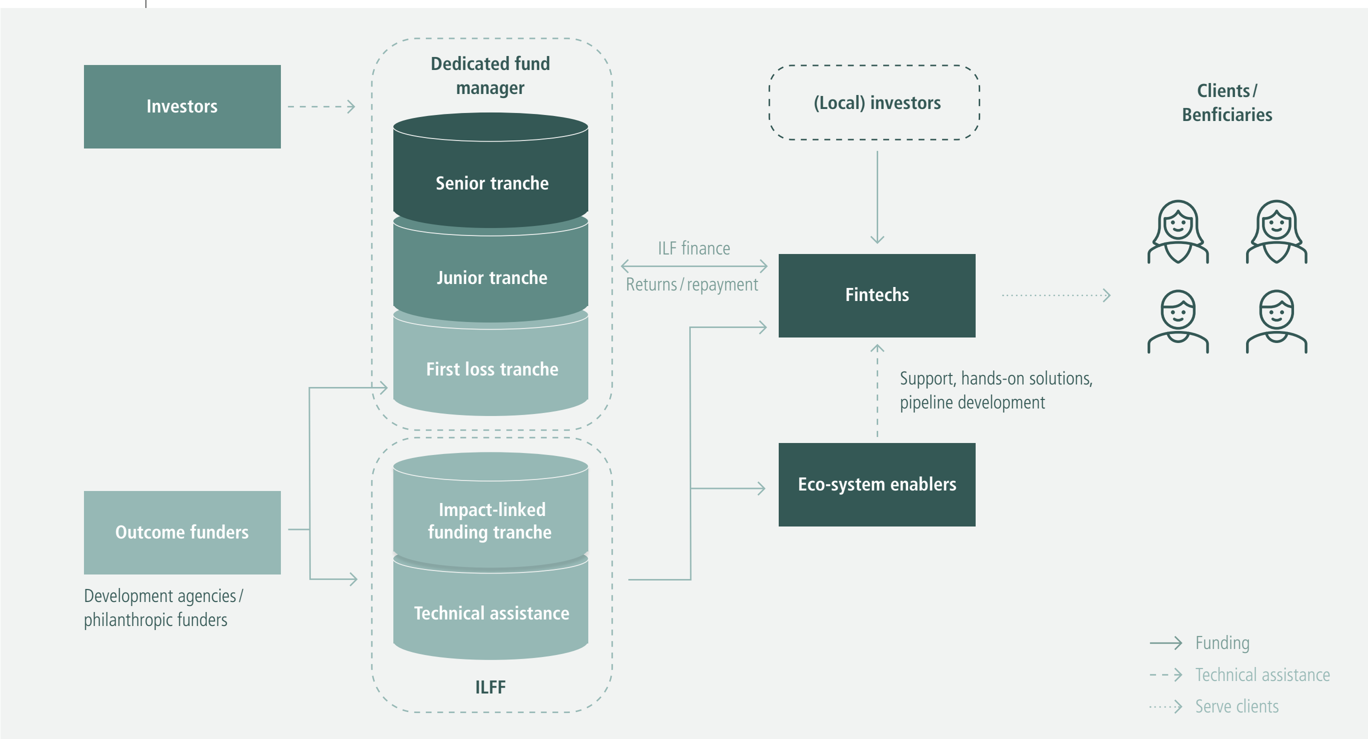


Figure 3. Impact-Linked Fund for Gender-Inclusive Fintech (phase 3)
Source: Based on Roots of Impact



Impact-linked finance mechanisms

The ILFF uses a variety of repayable and non-repayable ILF mechanisms that have several distinct characteristics: Most importantly, they directly link financial rewards to the achievement of positive social outcomes in order to enable market-based organisations to deepen or scale their impact and, in case of SIINC, to incentivise private capital providers to invest in organisations that they would otherwise consider too risky or not sufficiently profitable (yet) (financial additionality).

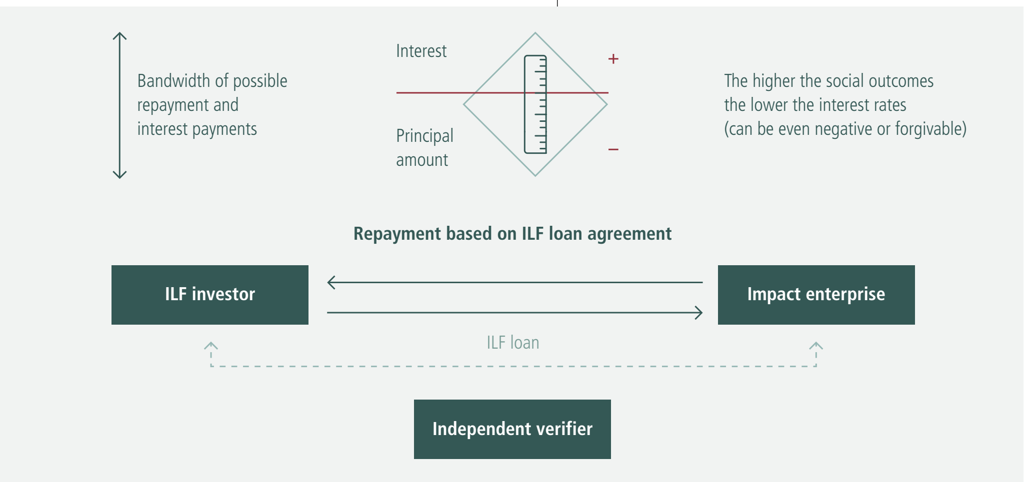
Financial rewards include direct incentive payments to these organisations for the additional impact created but also reduced interest rates or favorable repayment obligations. Market-based organisations include a range of institutions from SIEs to traditional enterprises, funds or financial institutions that are incentivized to generate more positive impact. ILF payments often enable incentivised organisations to create additional outcomes that would otherwise not have happened. That could mean, for example, more, faster, and/or better (financial) services and products to less profitable, lower income or more vulnerable customers, or the delivery of those in more remote areas (developmental or impact additionality).

ILF encompasses grants as well as a broad range of other financial instruments including debt and equity. Social Impact Incentives (SIINC) for example, are grants provided by a philanthropic organisation, a development agency or a public funder to reward SIEs with time-limited payments for achieving impact that would otherwise not have happened (or to a lesser extent) such as targeting of even lower income segment or disadvantaged geographical areas. In that way, SIINC payments not only help the enterprise to deepen and scale its impact, but they also increase the SIINC enterprise's profitability and thus help SIEs become more attractive to potential investors and lenders.[2]

Other ILF mechanisms link funding terms to social outcomes. For example, an impact-linked loan ties the level of financing costs or repayment obligations to the borrowers' achievement of pre-defined and independently verified outcomes (see Figure 4).

Other ILF variants include reimbursable SIINC, convertible SIINC, impact-linked convertible notes, impact-linked revenue-share agreements, impact-linked guarantees or impact-linked redeemable equity.[3]

Figure 4. Impact-linked loans
Source: Based on B-Briddhi (2021)
Innovative Finance Toolkit



[2] Koenig, A.-N. (2022a). Social Impact Incentives (SIINC): Rewarding for Social Outcomes and Mobilising Capital for Impact. SDC Case Series of Innovations in Private Sector Engagement. Swiss Agency for Development and Cooperation

[3] Some of the above variants are explained in more detail in the Innovative Finance Toolkit developed by Roots of Impact within the scope of B-Briddhi, an eco-system building program in Bangladesh with support by SDC (access here)

4. Benefits and Insights

Benefits of the Impact-Linked Finance Fund

Pooling ILF funding sources and the management and deployment thereof as it is done by the ILFF has some significant benefits compared to funders supporting individual impact-linked finance transactions:

- **Professional expertise**
  Funds are managed by professional fund managers with (sector) expertise and experience in due diligence and fund portfolio management.

- **SDG thematic targeting**
  Funders (and cooperating investors) can target specific SDG themes that best fit their respective priorities and investment strategies such as women empowerment, climate smart agriculture, education, or off-grid energy.

- **Alignment for systemic impact**
  ILFF funders have an opportunity to align their interventions with other funders and thus catalyse larger amounts of capital in a given thematic field or geography. They can strategically incentivise a broader range of actors across the ecosystem or along a value chain resulting in synergies and ripple effects across the entire portfolio of an ILF funding window.

- **Cost effectiveness**
  Compared to individual transactions or programmes by single grant makers, joint management of pooled resources reduces costs and improves the quality of investment decisions as well as the support to investees and partners.

- **Field building**
  Based on continuous evaluation and learning from its increasing thematic and geographical portfolio of funds and facilities, the ILFF is uniquely positioned to contribute to the standardisation of ILF, distribute and share knowledge, and build capacity on ILF practices internationally.

Benefits of impact-linked finance

ILF mechanisms vary significantly as to how they are designed and structured, but they share the following benefits compared to traditional financing mechanisms:

- **Incentivising impact**
  ILF encourages market-based organisations to maximise their impact and to establish internal impact management practices and culture, therefore protecting the organisations against mission drift in the long-term.

- **Providing value for money**
  ILF allows grant makers to use their scarce concessional resources more efficiently by paying only for additional outcomes for a time-bound period. Such instruments also offer a simpler contractual structure compared to other outcome-based finance mechanisms, thus reducing transaction costs.

- **Wider applicability**
  ILF can be designed in a very flexible way, allowing a wide range of applications across sectors, geographies, investment instruments (debt, equity, hybrid or bonds), and types of investors/investees.

- **Mobilising additional investment (in case of SIINC)**
  By increasing the entrepreneurs' profitability for a time-limited period, SIINC helps impact entrepreneurs to mobilise additional investment capital during critical stages of their development.

- **Better risk allocation (in case of SIINC)**
  SIINC shifts both the impact and financial risk from the grant makers to the investors and impact entrepreneurs who should be better placed to control and minimize these risks.

Insights

While the ILFF is still at an early stage, existing reviews of ILF pilots and recent developments allow for the following insights on the emerging field of ILF:

- **Increased interest**
  Evidence of ILF pilot programmes confirmed the potential of ILF to help deepen impact and to use scarce grant money catalytically to mobilise additional private capital.[5] Since its establishment in 2020, the ILFF has successfully raised visibility and developed pooled ILF products and services that allow funders to take pilots to scale and enhance opportunities for systemic impact. Increased interest and commitment to the ILF funding windows has confirmed that there is a case for intermediary fund management and eco-system building services in ILF. As of March 2022, the ILFF has already been able to attract close EUR 25 million not only from development agencies, the original promoters of ILF, but also from pioneering philanthropic funders for its first three impact-linked funds.

- **ILF learnings**
  Learnings from ILF pilots have been gathered and shared via trainings, publications, and other tools published on the ILFF Open Platform. Key learnings include:

  - **Impact target setting**
    The success of ILF interventions depends on how additional impact has been identified and rewarded, how targets have been set to respond to the specific situation of entrepreneur as opposed to standardised targets, and to what extent targets were both ambitious and sufficiently flexibly to respond to changes in external circumstances (e.g. COVID-19). ILF has strengthened impact measurement and management capacities of the incentivised organisation – a value beyond the actual ILF payments.

  - **Pricing**
    Pricing the incentivised impact remains a challenge in all ILF transactions: should ILF payments (or financing cost reductions) be set in relation to the entrepreneurs cost of achieving the additional impact, the opportunity cost of the incentive or to the levels that would be set in accordance with existing market offers. In SIINC, the incentive pricing needs to be sufficient to meet the cost of the incentivised organisation and enhance profitability to make it attractive to potential investors but not too high to distort the existing market for enterprise finance.

  - **Partnerships for transformative impact**
    It is key to form effective partnerships with intermediaries such as accelerators or start up programmes that can facilitate access of ILF funders to potential investment propositions with easily scalable high-impact business models. The ILFF offers opportunities to strategically include key intermediaries in ILF programmes to incentivise engagement of important eco-system players for better outreach and transformative impact.

5 Investing for Good (2021). A review of impact-linked finance: does incentivising impact work.

5. Outlook

The work of the ILFF to grow the range of ILF solutions and investment opportunities and increase awareness, experience, and evidence about the benefits of ILF practices will be shaped by the following developments:

- Increased availability of evidence and data to allow for a better assessment, comparability, and communication of value for money as well as of the financial and development additionality. Furthermore, better data enables a better determination of pricing impact and incentives setting.
- The use of digital tools and effective self (or user) reporting to reduce the cost of ex-ante and ex-post verification of ILF transactions.
- An increased willingness to experiment with the full range of impact-linked instruments and learn from these experiments by analysing and sharing evidence.
- Rapid expansion to a wider range of actors in the social, private, and public sector including corporations and financial institutions.
- Combining ILF effectively with structured funds or guarantee vehicles and other innovative finance mechanisms to mobilise larger scale and more commercially oriented investors.
- The integration of eco-system enablers such as accelerators, venture builders, and investor networks into ILF programmes to achieve a transformative impact in a certain thematic sector or local eco-system.
- The application of ILF to traditional organisations, start-ups, enterprises, and financial intermediaries to shift their business model or investment strategy towards impact or encourage established corporates to target specific high-impact pilot opportunities around their core business.
- Governments setting a minimum impact target for the private sector and allowing ILF products to become tradable in capital markets following the example of carbon emissions trading mechanism.

6. Additional Resources

B-Briddhi (2021). Innovative Finance toolkit
Download here.

Investing for Good (2021). A review of Impact-linked finance: does incentivising impact work?
Download here.

Koenig, A.-N. et al. (2020). Innovative Development Finance Toolbox.
Download here.

Koenig, A.-N. (2022a). Social Impact Incentives (SIINC): Rewarding for Social Outcomes and Mobilising Capital for Impact. SDC Case Series of Innovations in Private Sector Engagement. Swiss Agency for Development and Cooperation.
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Koenig, A.-N. (2022b). Incentivising Lenders: The Case of the Catalytic Market Facility Aceli Africa (Aceli). SDC Case Series of Innovations in Private Sector Engagement. Swiss Agency for Development and Cooperation.
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Roots of Impact & Boston Consulting Group (2019). Accelerating Impact-linked finance.
Download here.

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