

What it takes:

Scaling Impact-Linked Finance implementation capacity

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Abstract

Impact-Linked Finance (ILF), a range of financial solutions for market-based organisations that link financial rewards to social outcomes, has emerged from the evolving field of outcomes funding to support impact enterprises in pursuing high-quality impact while scaling toward commercial viability. The benefits of ILF are directed toward impact enterprises and outcome payers, who effectively pay only for impact created. However, broader adoption by transaction managers is necessary to scale implementation capacity and make the solutions accessible for impact enterprises. This study conducted a cross-country exploration of the factors influencing adoption of ILF by transaction managers, addressing two primary research questions: the limiting factors preventing the adoption of ILF and the enabling factors that facilitate its use. A qualitative approach was taken by conducting a comprehensive review of existing literature, interviewing twenty transaction managers about their respective experiences and perceptions, spanning impact investors, grantmakers, non-profit organisations and advisors, and conducting a thematic analysis of the data collected.

The findings from the thematic analysis identified that for transaction managers for which ILF is a relevant strategy, key enabling factors include the availability of concessional and flexible funding to test and develop an ILF implementation approach; whether transaction managers are oriented towards innovative finance; and that a transaction manager is willing and able to prioritise impact goals in their investing activities. Conversely, eleven significant barriers limit ILF adoption. A predominant challenge is the lack of awareness of ILF, given its niche status and limited track record. This is exacerbated by a scarcity of experts with the necessary skills for high-quality ILF implementation, creating a bottleneck for supporting new adopters. Further, the complexity of ILF, including the balancing of diverse stakeholder interests, legal challenges, and the intricacies of structuring transactions, poses considerable difficulties. Particularly, transaction managers face challenges when target investees struggle to meet ILF's rigorous impact data requirements, often accompanied by high transaction costs.

The study concludes that overcoming these barriers requires targeted interventions and market-building efforts to bolster ILF adoption. The research underscores the need for a concerted effort to increase awareness, build capacity, and streamline processes to leverage ILF's full potential in achieving the UN Sustainable Development Goals.

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List of Abbreviations

C3	Catalytic Capital Consortium
DFI	Development Finance Institution
ESG	Environmental, Social or Governance
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH
IBWG	Impact Bonds Working Group
ILF	Impact-Linked Finance
ILL	Impact-Linked Loan
IMM	Impact Measurement and Management
LP	Limited Partner
MSDF	Michael and Susan Dell Foundation
RBF	Results-Based Finance
SDC	Swiss Agency for Development and Cooperation
SDGs	UN Sustainable Development Goals
SSN	Social Success Note
TA	Technical Assistance

Chapter 1: Introduction

1.1 Introduction and background of the study

Achievement of the UN Sustainable Development Goals (SDGs) is restricted by an annual financing gap of about US\$ 4 trillion (UNCTAD, 2023). The resultant question of how to make finance work towards positive environmental and social impact is at the core of the developing impact finance industry. To enable the implementation of critical solutions, there is an urgent need for the industry to maximise impact capital efficiency and mobilise private sector capital en masse to supplement public sector and philanthropic investment. Many such solutions come from impact enterprises – for-profit businesses working toward positive social or environmental change – who are estimated by the World Economic Forum to contribute 2% of global GDP (more than apparel, telecoms or advertising) and have directly impacted over 891 million people in the last 25 years (Bonnici, 2024). These enterprises experience a US\$ 1.13 trillion financing gap, and Impact-Linked Finance (ILF) has emerged as an innovative finance response to support impact enterprises to scale their interventions toward commercial viability while prioritising their impact mission.

ILF refers to “financial solutions for market-based organisations that directly link financial rewards to the achievement of positive social outcomes” (Baic et al., 2019, p. 5), comprising concessional financial instruments that span asset classes and centre the impact enterprise as the key value creator in its investment structures. It enhances impact capital efficiency by linking calculated financial rewards to impact outcomes, thus directly contributing to impact additionality, and introducing recyclable instruments (i.e. repayable financial instruments) for purposes often funded by non-recyclable instruments, such as grants. As a form of catalytic capital, ILF fosters third-party investment, mobilising private sector capital through various uses (Leijonhufvud et al., 2019). ILF can be used to close the commercial viability gap that many impact enterprises face through the early and growth phases, while avoiding mission drift. By incentivising robust impact measurement systems amongst potential investees, ILF prepares enterprises for future impact investments, while allowing philanthropic and public sector funders to pay only for guaranteed impact outcomes (Baffioni & Crisci, 2022; ILF Fund, 2023a).

As ILF has emerged over the past decade, there has been much interest from outcome payers for its uses and benefits, however, the stakeholder group responsible for administering the mechanisms of ILF, referred to here as transaction managers, have been slow to adopt the

investment strategy and are poorly understood in existing literature, despite being integral to building implementation capacity towards impact at scale. The few early implementers of financial incentives for impact tend to be strongly impact-first (in contrast to profit-first) or innovative finance practitioners; an example being Roots of Impact who pioneer ILF in line with developing design principles, alongside other market-building activities (Buckland et al., 2021). Baic et al. (2019) simultaneously coined ILF and identified that transaction managers are prevented from adopting ILF due to a lack of awareness, ILF's lack of theory and track record, a lack of knowledge and experts who possess said knowledge, a lack of internal expertise and operational capacity to adopt ILF processes, complexity and costs in meeting the data requirements of ILF, the scarcity of pipeline, and complexity in balancing multiple stakeholder interests.

To enable adoption of ILF by more transaction managers, market-builders have introduced platforms for knowledge-sharing and are developing a community of practice around ILF (ILF Fund, 2024). This study aims to support such efforts to scale ILF implementation capacity by providing deeper insight into theories and experiences underscoring the relationship between potential transaction managers and ILF.

1.2 Research Problem and Questions

The developing impact finance industry places escalating reliance on impact enterprises: commercial, impact-driven businesses that can deploy innovative localised solutions with the potential to expand and perpetuate impact through self-sustaining business models (Struwer et al., 2022). Such enterprises experience a US\$ 1.13 trillion financing gap (Bonnici, 2024), and contemporary impact finance is working to leverage catalytic sources of finance to attract private sector capital toward impact enterprises through blended investment structures, in the context of the larger effort to plug the US\$ 4 trillion SDG financing gap (UNCTAD, 2023).

Still, much capital ear-marked for impact objectives is underutilised despite the urgency of the SDGs, as innovative methodologies to efficiently catalyse additional investment and additional impact are not yet applied at scale. For example, grants are an essential part of the impact finance toolkit; however, when provided to market-based organisations, they draw focus to the activities of impact enterprises, rather than resultant impact outcomes, and lack structuring to meaningfully support and incentivise impact enterprises that have the potential to scale and enhance impact creation.

ILF is built on the foundations of contemporary impact finance and encompasses a cluster of financial instruments that link financial rewards to verified impact outcomes. This directly incentivises additional impact creation through investment, alongside supporting financial additionality by improving impact enterprises' financial positions and helping them to scale while prioritising positive social outcomes (Baffioni & Crisci, 2022). ILF as a financial strategy is in its infancy with literature regarding its efficacy only beginning to emerge in the past four years (Roots of Impact, 2020).

Philanthropic and public sector outcome payers currently drive nascent market growth, as the benefits of ILF's pay-for-success strategy are attractive for their deep impact focus and ability to pay for guaranteed impact (Buckland et al., 2021); however, a limited number of transaction managers have engaged with ILF, whose involvement is essential for scaling implementation capacity globally. Scaling of ILF presents an opportunity to mobilise a larger quantum of catalytic capital toward achieving the SDGs and affecting critical financial systems change for sustainable development.

Existing research on the matter is dominated by practitioner reports, which broadly explore the nature of ILF relative to other innovative financing mechanisms, as well as case studies of its applications. However, targeted and theory-based research is required to better understand how a base of transaction managers may be engaged to allow for scaling ILF, such that it can be made as broadly accessible to impact enterprises as possible.

To better define the relevant factors of transaction managers' decision to adopt ILF, this study addresses the following questions:

- i. What are the limiting factors experienced and perceived by transaction managers that prevent adoption of ILF where it would be suitably applied?
- ii. What are the enabling factors experienced and perceived by transaction managers that increase the use of ILF?

1.3 Research objectives

The purpose of the study is to understand the key factors underlying current and potential adoption of ILF by transaction managers around the world with a view to inform industry builders in the pursuit of financial strategies to holistically optimise impact outcomes. The objectives of this study are as follows:

- i. To explore the factors preventing adoption of ILF by transaction managers and limiting implementation capacity in the broader ILF market; and

- ii. To understand the factors that draw transaction managers to adopt ILF from their current experiences and perceptions of ILF.

1.4 Scope and Justification of the study

Scope

As a relatively new field of innovative finance, there are significant gaps in existing research on ILF, particularly from an academic approach. The following bounds are applied to this study.

Corporates may be eligible for ILF, however current ILF experiences to date focus on small- and -medium sized impact enterprises – particularly scalable impact enterprises looking to achieve financial sustainability to access traditional financial support. This study will therefore focus on the latter group.

The impact of reduced grantmaking activity on grant-funded entities, potentially as a result of ILF, is not explored alongside consideration of how concessional funds should be allocated between aid, impact and development objectives.

Justification

Academic research on ILF is in its infancy and research in the area will likely continue to be led by practitioners eager to gain ground on the frontiers of innovative finance, as ILF presents an opportunity to drive guaranteed and measurable impact creation to meet the urgency and scale of development required to address the SDGs. The field of ILF faces complex challenges in this pursuit. Many of these challenges are shared with other innovative and impact-oriented financing strategies, such that a rising tide of empirical evidence may be expected to provide frontier-wide benefits.

Capacity-builders and intermediaries in ILF can benefit from the clarity this study provides on how transaction managers may respond to industry-building efforts, such that they may adjust their approach or the design and narratives around financial instruments to accelerate growth of the industry in the interest of the shared goal of enhanced impact creation.

Enabling these intermediaries to better address the transaction manager stakeholder group is expected to improve access to ILF upskilling and implementation support.

1.5 Organisation of the study

Chapter 1 provides the study background, the research problem, alongside research questions and objectives, closing with justification for the research.

Chapter 2 synthesises existing research in the research area, starting by defining relevant terms, then providing an overview of ILF as the core subject matter. Following this is a review of relevant theory to build a preliminary conceptual framework of the enabling and limiting factors influencing ILF adoption amongst transaction managers and documents a detailed examination of existing empirical literature.

Chapter 3 describes the methodology and research design applied in conducting the study.

Chapter 4 discusses the findings from thematic analysis of primary data collected.

Chapter 5 concludes the study with a summary of its findings and recommendations for ecosystem actors to engage transaction managers to scale ILF.

Chapter 2: Literature Review

2.1 Introduction

This chapter comprehensively reviews literature relevant to ILF. It defines key terms, provides an overview of the central subject matter, and creates a conceptual framework that speaks to the enabling and limiting factors influencing transaction managers' adoption of ILF.

2.2 Definition of terms and concepts

2.2.1 Additionality

Relative to the impact that an impact enterprise creates for its focal customers, suppliers or environment, “additionality” relates to the impact that an investment has on the impact enterprise. Brest and Born (2013) explain “additionality” for an investment to be the extent to which resources are provided that add to what would have been provided by other investors if the transaction had not happened.

They argue that an investment is only impactful where it seeks to produce beneficial impact outcomes that would not occur without the investment. Since 2013, the impact finance industry has begun to more clearly distinguish between impact investments that feature “additionality” and constitute catalytic capital with a focus on impact, from impact investment models such as ESG (environmental, social or governance) investing or sustainable investing, which seek risk-adjusted market returns in markets where purely commercial investors are often active and employ strategies such as screening investments or ESG integration (Foroughi, 2022). A key defining feature between these two groups on the impact investment spectrum is “additionality”.

Specific definitions of “additionality” differ between spheres of its use. Development finance institutions (DFIs) and multilateral development banks define additionality for projects to measure their efficacy and ensure that scarce concessional funds are not used where commercial capital can be deployed (World Bank, 2023). Environmental policy and carbon offset intermediaries define “additionality” for policy interventions as measured against a baseline scenario where the intervention is absent (Gillenwater, 2012). Ultimately, whether a policy, a project, an investment, or another intervention is considered, the definition of “additionality” maintains the principal feature of creating beneficial impact outcomes that would not occur without the intervention.

This study differentiates further between “financial additionality” and “impact additionality” in line with Baffioni and Crisci (2022) and the World Bank (2023). “Financial additionality” refers to additional investment to enable leverage or scaling of resources that would not have otherwise been accessible. “Impact additionality” refers to additional impact outcomes that would not have occurred otherwise.

2.2.2 Catalytic capital

The Catalytic Capital Consortium (C3) defines catalytic capital as patient, risk tolerant, concessionary, and flexible investment capital. In contrast to investments that seek market-rate returns, catalytic capital anticipates below market-rate returns or absorbs risk associated with unproven enterprise, markets, or innovations. They noted that the aim of catalytic capital is to unlock, or “catalyse”, impact and additional investment that would not otherwise have been achievable (C3, 2019).

Leijonhufvud et al. (2019, p. 5) applied the definition of “debt, equity, guarantees, and other investments that accept disproportionate risk and/or concessionary returns relative to a conventional investment in order to generate positive impact and enable third-party investment that otherwise would not be possible.” The latter definition builds on the former and is applied in this proposal, although with the explicit inclusion of grants as a catalytic capital investment where they are used to generate impact or additional investment, as they are widely understood to be catalytic (Struwer et al., 2022).

In a series of convenings of catalytic capital practitioners, the European Venture Philanthropy Association (EVPA, recently renamed to Impact Europe) found that the definition of catalytic capital is less clear in practice, as interpretations differ dependent on the context and level of application. However, the most common elements of the catalytic capital definition brought up by practitioners were that an investment constitutes catalytic capital only where impact is generated that would not have happened otherwise, in other words that it features additionality, and that grants can constitute catalytic capital (Cafferkey & Gaggiotti, 2022; EVPA, 2023).

2.2.3 Impact enterprise

Sometimes called social enterprises, impact enterprises are commercially viable or market-based entities with a mission aligned with environmental or social impact objectives (Bolis & Alexander, 2017). Impact enterprises range from small-to-medium-sized entities to established businesses at scale and include microfinance providers and cooperatives (McCallum & Viviers, 2020).

2.2.4 Impact-Linked Finance

ILF is defined by Baic et al. (2019, p. 5) as “financial solutions for market-based organisations that directly link financial rewards to the achievement of positive social outcomes.” This term is not commonly known across impact finance segments; where it is in use, the definition is most frequently applied in existing literature (Baffioni & Crisci, 2022; Bove et al., 2023; König, 2022; Naeve, 2022).

Buckland et al. (2021, p. 6) applies a broader definition: “the linking of financial incentives to social purpose organisations to the achievement of social performance targets.” The key differences between these definitions is the focus on market-based organisations in the former, and its specificity around social outcomes, rather than social performance targets. Both definitions refer to a pre-agreed impact goal, which the impact creator is rewarded for achieving, with an implicit reference to an agreed framework of verifying achievement of the goal.

Given the nascent market stage, Buckland et al. (2021) points to a lack of consensus on the precise boundaries and meaning of ILF. Some prefer ILF as a broad umbrella term without imposed conditions, while the Baic et al. (2019) definition refers to a distinct family of financial instruments that align with a developing set of design principles that prioritise practical rigour and calculated efficiency of impact incentivisation, having undergone advanced conceptualisation, per section 2.3.

In parallel with this conceptual development, a number of practitioners have developed simpler variations of impact incentivisation, which meet the latter definition (Aceli Africa, 2023; Amazonia Impact Ventures, 2024; Buckland et al., 2021). However, whether such approaches meet the former definition is often unclear from public information on characteristics such as the nature of target metrics (outputs versus outcomes), the presence of external verification, or other design principles.

To navigate the imprecise variety of ILF approaches, Buckland et al. (2021) utilises these characteristics, as well as the number of stakeholders to an ILF transaction, to stratify the imprecise variety of ILF into low, medium, and high complexity transactions. This is useful approach to understand how ILF approaches vary. Impact bonuses provided by Beneficial Returns are given as an example of low-complexity ILF, whereby loans are structured to incentivise impact outputs, are not verified and the lender is also the outcome payer such that there are only two stakeholders involved: the lender and the borrower. Social Success Notes

(SSN) are used to describe high-complexity ILF, as the transaction involves an investor, an outcome payer, a verifier and an investee, with an in-depth verification process, although incentives are based on outputs. SSNs are structured to reward both impact enterprises and risk-bearing impact investors for pre-determined impact targets.

This study applies the Baic et al. (2019) definition, classed as medium complexity, as it is more generally applied in existing literature as noted above, it aligns with innovative finance advancements through its design principles, and importantly takes a rigorous methodological approach towards efficiency in catalysing additional impact and investment for impact enterprises, which aligns specifically with the research problem in section 1.2.

Social and development impact bonds share the pay-for-success model regarding impact outcomes as ILF; however, these instruments are excluded from the definition as they relate to specific, time-bound projects as opposed to market-based organisations (Joffe, 2022).

2.3 Overview of Impact-Linked Finance

Catalytic capital is an increasingly prominent tool in the sphere of impact finance with focus being placed on developing and supporting such innovative financing mechanisms to bridge the SDG funding gap and shift financial systems in the interest of sustainability and justice. The movement towards the strategic use of catalytic capital at scale commenced over two decades ago, preceding impact investment and several other impact finance tools, led by philanthropic funders (Schwartz, 2017).

ILF is one such innovation to support impact enterprises to prioritise their impact through scaling from seed, early or growth stage (Baic et al., 2019; B-Bridghi, 2021). This is in the context of a major shift in impact attention from non-profit organisations to impact enterprises, which have the potential to affect commercially sustainable impact leveraging local knowledge and with the right support. A recent study by the Schwab Foundation for Social Enterprise revealed that roughly 10 million impact enterprises globally, or 3% of all businesses, generate US\$ 2 trillion in annual revenues (more than the telecoms or apparel sectors), with over 891 million lives directly impacted since the turn of the century (Bonnici, 2024).

BCG and Roots of Impact coined the term ILF in 2019 (Baic et al., 2019), which refers to a range of financial solutions across asset classes for market-based organisations whereby financial rewards are directly linked to the achievement of predetermined and verified impact outcomes, or outputs where there is evidence of a strong linkage to an outcome (Baffioni & Crisci, 2022). Table 1 lists ILF instruments as they are currently understood, although

documented experiences of ILF to date are clustered around Social Impact Incentives (SIINCs), Impact-Linked Loans (ILLs), and Impact-Ready Matching Funds (Roots of Impact, 2023b). Given the nascency of ILF, it is anticipated that the list of instruments and the practice of ILF will continue to be developed.

Table 1: The Scope of ILF

Blended ILF instruments	Non-blended ILF instruments
SIINC	Impact-Linked Payments
Impact-Linked Loan	Impact-Linked Loan
Impact-Linked Revenue or Profit Share Agreement with Compensation	Impact-Linked (Convertible) Note
Impact-Linked Guarantee	Impact-Linked Revenue or Profit Share Agreement
Impact-Linked Loan Guarantee	
Impact-Linked Portfolio Guarantee or First-Loss Capital	Impact-Linked First-Loss Capital
Impact-Linked Shares with Compensation	Impact-Linked Shares
Impact-Ready Matching Fund	

Source: ILFF (2023a)

“Blended ILF instruments” refers to transactions that necessarily blend public or philanthropic funding with private sector investment, whereas “Non-blended ILF instruments” need not feature such a blend.

SIINCs pre-date coinage of the term ILF and have been deployed since 2017, with practitioners noting the instrument has strong impact additionality. A SIINC involves making periodic payments to impact enterprises for the positive impact created by their operations, based on a set of pre-determined incentives that align to impact enterprises’ operations, impact mission and feasible data collection options. Impact enterprises are then able to recognise receipts for verified impact outcomes as revenue, thus internalising impact that is usually externalised, and growing revenue to attract additional investment. SIINCs are classified as a blended instrument in Table 1, as they constitute catalytic investments made alongside other fundraising in a blended structure (Baic et al., 2019; Choritz et al., 2018; SDC & Roots of Impact, 2016).

Per section 2.2.4, the boundaries between ILF and adjacent instruments (more complex outcomes funding or less complex results-based finance (RBF)) are unclear due to the modular nature of transactions and the market’s nascency (Buckland et al., 2021). This study concerns itself with ILF as co-developed by the Swiss Agency for Development and Cooperation (SDC) and Roots of Impact; characterised by practical rigour and advanced conceptual development.

Without clear language to differentiate ILF from ILF-adjacent transactions in existing literature, it appears that ILLs are the most common ILF instrument, which vary the interest rate on a debt facility based on the achievement of impact outcome (Buckland et al., 2021; ILF Fund, 2023a). The instrument is referred to interchangeably with “interest rate rebates”, “impact-linked debt instruments” or “pay-for-success” debt instruments, but it is distinct from instruments like sustainability-linked loans that adjust borrowers’ cost of debt based on a sustainability score (Boggild, 2021). However, if only transactions that certainly apply ILF design principles are considered, SIINCs are the most frequent instruments used (Roots of Impact, 2023b).

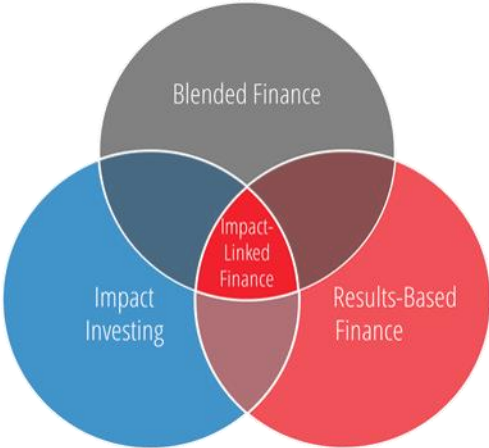
Empirical research on the geographic spread of ILF transactions to date is unavailable, and definitive identification of ILF transactions from those that partially apply ILF principles is challenged by the lack of commonly applied language (for example, by linking funding to impact outputs). Reviewing extant literature, it appears that the landscape of ILF aligns to that of global impact finance, wherein 92% of impact assets under management are controlled by organisations with headquarters in developed countries (Hand et al., 2022), while the majority of funds are targeted for investment in developing countries, and secondarily to emerging countries (Volk, 2021). ILF developments have been led and championed by organisations headquartered in developed countries (listed in the discussion of design principles below) that invest in a borderless and somewhat sector agnostic nature largely with the aim of demonstrating the approaches’ viability in developing countries, where there is a significant SDG investment need and transaction costs may be lower (Buckland et al., 2021).

While caution should be taken not to generalise the applicability of ILF instruments between different developing markets as the practice grows, innovative finance practitioners are responding to the urgent SDG financing gap by deploying their investment strategies globally, regionally or bilaterally within developing and emerging countries. Regional learnings are being applied to globally to expedite the response to the SDG financing gap, for those learnings to be stress-tested and corroborated to improve the practice. For this reason, this study takes a global outlook in exploring the factors influencing adoption of ILF by transaction managers, in line with the majority of existing ILF literature.

ILF incorporates elements of impact investment, blended finance, and RBF financial strategies as depicted in Figure 1. Like impact investing, ILF investments target commercially viable entities based on an investment mandate often informed by outcome payers. Unlike ILF, however, at present a majority of impact investors target returns at the risk-adjusted market rate (Hand et al., 2023) without targeting impact outcomes, thus focusing their impact lens on deal

selection. Like blended finance, ILF recognises the need to incentivise the investment of the mass of investors targeting such market rate returns, by utilising catalytic capital to finance projects or organisations with significant impact potential. Unlike ILF, blended finance structures may be investor-centric, thus risking mission drift amongst impact enterprises, and outcome measurement is often overlooked. Lastly, in common with RBF, ILF ties financial reward to predetermined results, however, ILF instruments measure impact outcomes wherever possible as opposed to direct outputs, and are catalytic and concessional, whereas RBF instruments rarely aim to crowd in commercial capital (Baffioni & Crisci, 2022; Baic et al., 2019). Outcomes in the context of this study refer to the short-to-medium term effects for individuals, groups, or issues and are a function of an impact enterprise’s inputs, activities, and direct outputs, as framed by the theory of change (Godeke & Briaud, 2020). Hornberger (2023, p. 181) points out: “as long as we keep monitoring and measuring our success based on the activities delivered, there is no incentive to maximise for impact.” ILF thus recognises impact enterprises as key value creator, such that incentive payments are structured to specifically incentivise an investee based on their context, rather than taking a standardised approach.

Figure 1: Impact-Linked Finance



Source: Roots of Impact (2023a)

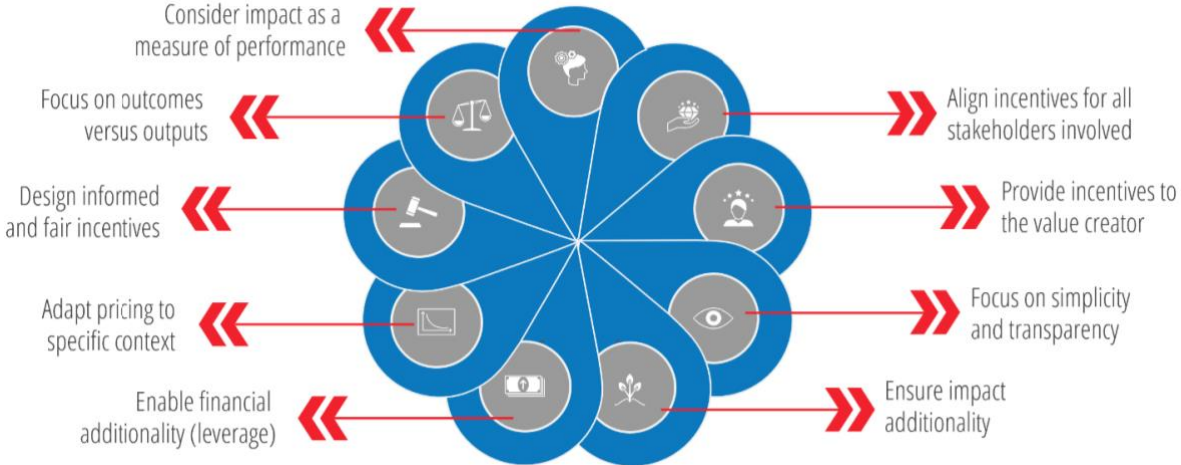
A set of design principles for ILF have been developed based on the experiences of practitioners to date, which include progressive outcome payers such as the Swiss Agency for Development and Cooperation (SDC), the KfW Development Bank, IDB Lab, Aqua for All, Jacobs Foundation, Medicor Foundation, Background Energising Development (EnDev), and the UBS Optimus Foundation (Baffioni & Crisci, 2022; Buckland et al., 2021), and transaction managers: Roots of Impact, iGravity, and the Impact-Linked Finance Fund, the latter of which

was set up by Roots of Impact and iGravity to pool resources and scale ILF in line with the recommendations discussed in section 2.4 (König, 2022; Naeve, 2022).

The design principles depicted in Figure 2 were developed to define the ILF practice, as part of a series of initiatives to disseminate knowledge on the effective use of ILF to various practitioners (Roots of Impact, 2023a). To date, outcome payers have more readily taken to ILF than transaction managers (Buckland et al., 2021), which can be inferred from the list of organisations above. This is likely a result of outcome payers being focused on impact creation and the attractiveness of paying for guaranteed impact, whereas transaction managers are dependent on applicable fund mandates and resource constraints that are detailed in section 2.4.

The key design principles extracted from Figure 2 per Buckland et al. (2021) are that: incentives are directed to the key value creator, being the impact enterprise; impact incentives are focused on outcomes instead of outputs; and that impact additionality is built into transactions, meaning that the financial rewards are structured to incentivise impact enterprises to create greater impact than they would otherwise have done.

Figure 2: Design principles for ILF



Source: Roots of Impact (2023a)

Importantly, as Bjoern Struwer from Roots of Impact notes, ILF “can be used to enable and incentivise market-based enterprises to accelerate and deepen their positive impact by generating additional outcomes, such as serving lower-income customers, women, or focusing on more rural areas” (Patton Power, 2021, p. 196).

Per Baffioni and Crisci (2022), the five main stakeholder groups in an ILF transaction are outcome payers, impact enterprises, transaction managers, investors and impact verifiers. Outcome payers are distinct from investors in that they own and provide funds in return for verified impact outcomes, and financial returns to varying degrees (Baic et al., 2019), whereas investors apply traditional financial products and prioritise financial and are thus unlikely to apply ILF. Central to this study are transaction managers, which are those organisations responsible for conducting the investment process on behalf of the outcome payer. Transaction managers are general partners in fund structures that include a limited partner (LP); they may also be implementing outcome funders (both a transaction manager and an outcome payer), and the term is inclusive of organisations that make grants or other impact-based investments.

State of research on Impact-Linked Finance

In-depth academic research on ILF as defined is almost entirely absent, save for a data analysis report on the first SIINC transaction's impact, and adjacent research on blended finance that references ILF under its umbrella (Kwon et al., 2022). The findings of the former report indicate a causal effect of the SIINC on the impact enterprise serving a higher degree of Bottom of the Pyramid customers, while the impact enterprise was seemingly unaffected in its ability to attract non-Bottom of the Pyramid customers (Bronsolero, 2020).

Otherwise, research is practitioner-led and largely driven by the actors involved in ILF transactions and outcome payers interested in the potential benefits of ILF. This research broadly defines ILF as a concept and contrasts it with financial strategies that share the features and objectives of ILF; reviews case studies of ILF transactions; describes ILF transaction structures and pain points; and makes observations on the effectiveness of ILF.

Therefore, the study is well-positioned to address the lack of academic research on ILF. As ILF scales, more academic research is anticipated, as with other financial innovations, and this study may provide empirical evidence and theory to support those works. The research also benefits from being topical as it is past halfway to the 2030 target of the SDGs, without sufficiently scaled financing solutions to fund necessary progress towards the goals. ILF builds on various emerging financing mechanisms to address this need per section 1.4.

2.4 Conceptual Framework

The lack of research has rendered limited theories for application with respect to the study's research questions; however, synthesis of the literature reviewed does provide theoretical insights that are used to propose a conceptual framework.

Theory-building is approached by understanding the broader theory of catalytic capital and conceptualising the position of ILF as catalytic capital; considering the circumstances and practitioners for which ILF is a beneficial financial strategy, which are synthesised into enabling factors in the conceptual framework; examining practitioner reports on limiting factors experienced by transaction managers with respect to ILF; and considering the drivers of those enabling and limiting factors for transaction managers. The conceptual framework in Table 2 is presented as a result of this analysis. The framework will incorporate the findings of this study to make clear the influences experienced by transaction managers for ILF industry-building actors. Per Jabareen (2009, p. 51), a conceptual framework offers “an interpretative approach to social reality”. This framework aims to provide a holistic interpretation of the reviewed literature to build an understanding of the research problem.

Table 2 focuses on the enabling and limiting factors faced by transaction managers, as documented in section 1.2. It also speculates on the drivers of each enabling and limiting factor, whether they are driven by the inherent design of ILF or its early stage of growth, or whether the factors arise due to potential transaction managers' positioning. This distinction is expected to support primary data analysis in that the specific features of transaction managers that facilitate or deter adoption of ILF can be understood with respect to the factors labelled “(TM)” or “(Mix)” to indicate to capacity-builders how and to whom targeted support is best suited.

Factors are split into columns based on whether the factors are expected to relate to general, upfront considerations for ILF adoption (column “Upfront”), or whether the factors are relevant to the type of deal structuring undertakings a transaction manager may encounter based on their impact focus areas, focus regions, or other circumstances specific to the potential transaction manager. Sector-level factors are split out to reflect the significant number of factors associated with these major investment processes, around which impact finance strategies are notoriously caught in tension between the need to deepen impact-orientation and rigour and the costs and availability of actors and resources with which to achieve this.

Table 2: Conceptual framework

	Upfront			Sector-level		
Enabling factors	Mission-aligned by design (TM)		Attractive to outcome payers (TM)		Limited financial trade-off (ILF)	
Limiting factors	Experience	Knowledge	Capacity	Regulatory (Mix) where also capital providers	Data	Attractiveness
	<i>Lack of awareness</i> (TM) <i>Insufficient track record</i> (Mix) <i>Lack of theory</i> (ILF)	<i>Existence of experts</i> (ILF)	Internal expertise (TM) Operational capacity (TM)		Impact and financial data requirement (ILF) Time and costs to obtain impact and financial data (TM)	<i>Scarce ILF investment-ready enterprises</i> (ILF) Complex balancing of stakeholder interests (Mix)

Noted: ILF refers to factors driven by the design and growth stage of ILF; TM refers to factors driven by the respective perspectives of transaction managers; and Mix refers to factors driven by a mix of both the design of ILF and the circumstances of transaction managers.

Source: Candidate’s design from literature reviewed.

Factors captured in italics in the conceptual framework may be expected to have an inverse relationship to ILF’s market penetration, such that as ILF adoption grows, so the following limiting factors will reduce in significance: “lack of awareness”, “track record build-up”, “theoretical base”, “existence of experts”, and “scarce ILF investment-ready enterprises”. This distinction is based on the nature of the factors considered together as indicators of a developed market around a financial strategy.

Three enabling factors were identified in the conceptual framework from the considerations of section 2.4.2, the strengths of which are relative to the potential transaction managers’ mission focus and dependence on outcome payers. “Mission-aligned by design” speaks to the appeal to transaction managers of ILF being purpose-built for enhanced impact creation, based on observed insufficiencies in impact finance and responsible investing strategies more broadly. Transaction managers who are explicitly committed to deep impact would thus be attracted to adopting ILF based on this factor. “Attractive to outcome payers” relates to transaction managers being incentivised to adopt methodologies that align with outcome payers, to support fundraising and the valuable relationship that transaction managers hold with outcome payers. As noted previously, the lion’s share of the benefits of ILF flows to outcome payers and impact enterprises, relative to transaction managers. Lastly, “limited financial trade-off” refers to deals that face a trade-off with financial performance to deepen their impact; however, that trade-off can be expected to resolve as the business achieves scale or builds an understanding of their market that shifts financial and impact performance into alignment for enterprises. Such deals are best suited for ILF support, making the benefits of ILF implementation more attractive to transaction managers.

The conceptual framework categorises the limiting factors in line with that of Baic et al. (2019): experience, knowledge, capacity, regulatory, data, and attractiveness, as detailed in section 2.4.3.

This conceptual framework is an interpretation based on the literature reviewed, but a one-size-fits-all approach is not suitable for the diverse perspectives of potential transaction managers of ILF. The components of the framework are intended to be generic such that they can be observed and compared between contexts. Adjustment is likely to be necessary for specific applications of the framework. Similar visual conceptual frameworks have not been identified in existing research; therefore, comparison and refinement using the work of other researchers is not possible.

2.4.1 Broad theory of catalytic capital

Patton Power (2021) describes the spectrum of returns experienced by different impact-aligned financial strategies, ranging from -100% returns for traditional grants and 0%+ return on impact investments, where at least the principal is recovered depending on investors' mandates. The intermediate range from -100% to 0% is increasingly being filled by philanthropic and other concessionary funders with innovative financing mechanisms, many of which constitute catalytic capital.

C3 (2019) theorises the hallmarks of catalytic capital as patience, risk tolerance, concessional, and flexibility. As an authority on catalytic capital, it describes the objectives of the concept to be additional impact creation and the unlocking of additional capital that would not otherwise be channelled to impact creation.

Leijonhufvud (2019) adds to C3's theory by positioning catalytic capital within the broader context of financial strategies, encompassing a range of financial strategies that do not seek risk-adjusted market returns but do target measurable impact solutions, meet impact enterprises' capital needs, and catalyse additional investment, inclusive of grantmaking activities, as depicted in Figure 3.

Figure 3: Positioning catalytic capital in the broader spectrum of capital



Source: Leijonhufvud et al. (2019)

Inherent in the catalytic capital as defined is that it includes investments that accept disproportionate risk, but may not accept concessionary returns. Such transaction structures have a stronger relationship with financial additionality than impact generation, whereas concessionary catalytic capital structures have a more direct observable relationship with impact generation. ILF instruments constitute concessionary catalytic capital with a strong focus on impact additionality built into transaction structures by linking financial rewards to impact outcomes per section 2.3.

Reflecting on ILF's position in Figure 3 on the above basis, it constitutes a subset of catalytic capital that not only seeks to facilitate additional investment by filling capital gaps for impact enterprises, but also seeks to facilitate additional impact by providing better financial terms for better impact outcomes. While it resembles grantmaking as ILF accepts concessional returns, ILF would not overlap with philanthropic grantmaking in Figure 3 because of its defining feature of linking financial rewards in the investment structure to verified impact outcomes.

Leijonhufvud et al. (2019) developed a theoretical framework for the forms, roles, uses and results of catalytic capital discussed below. There are ILF instruments that interact with all of the forms, roles, uses and results listed below, although some forms have no observable track record as yet, such as an Impact-Linked Guarantee.

The concessionary nature of catalytic capital is encapsulated by five forms, or the "five Ps", that it takes: price (accepting below market-based returns); pledge (such as guarantees); position (such as subordinated security positions); patience (accepting longer durations or uncertain timing on exits); and purpose (utilising non-traditional terms in the interest of the impact enterprise's needs) (Leijonhufvud et al., 2019).

Catalytic capital commonly fulfils the following roles for impact enterprises: at an early stage, seed funding in the form of patient equity or convertible debt; for scaling, growth capital often in the form of concessionary debt, equity, or hybrid instruments; and for sustaining, typically, concessionary debt and long-term guarantees are suitable.

Catalytic capital is used to facilitate innovation and help build a track record, in so doing leveraging additional investment, signalling impact potential, and maintaining mission alignment.

Finally, the result of catalytic capital is “expanding, deepening, or otherwise amplifying positive social and environmental outcomes” (Leijonhufvud et al., 2019, p. 6).

2.4.2 Enabling factors: Circumstances and practitioners for which ILF is suitable

From the context of ILF as catalytic capital, insights may be drawn on the benefits of ILF for transaction managers. Benefits primarily flow to outcome payers, as they enjoy effective use of capital relative to impact creation (ILF Fund, 2023a), but it may be inferred that transaction managers capable of implementing ILF transactions will attract outcome payers looking for this benefit.

According to catalytic capital theory, Patton Power (2021) frames ILF instruments as necessary when the pursuit of impact outcomes does not align with financial performance. To illustrate, if a microfinance lender demonstrates that lending to women or providing financial literacy training leads to lower credit risk in the short term, outcomes based on lending to women or financial literacy training have the potential to be funded by capital that requires a market-based return, as the milestones align with financial performance. It becomes opportune to engage ILF where there is a perceived trade-off on financial performance in the short term to attain deeper impact.

Transaction managers that are necessarily mission-aligned with flexibility around return requirements to their stakeholders, such as foundations or family offices, are likely to be the first adopters of ILF, per Patton Power (2021). In contrast, Baic et al. (2019) argue that development or public outcome payers have the necessary flexibility to be first movers; indeed, this has been observed with the SDC and IDBs’ involvement in initial ILF transactions (Roots of Impact, 2020). Leijonhufvud et al. (2019) states that typical catalytic capital investors prioritise impact, and so expands on these suggestions to include foundations, DFIs, family offices, and high net worth individuals (HNWIs), as well as some corporates and corporate foundations, as likely parties to catalytic capital. Corporates are considered less likely to adopt

ILF, due to their limited understanding of the impact enterprise ecosystem (Liu & Nowack, 2024), and the complexity and impact skill level demanded by the framework.

It is evident from the breakdown of organisations currently engaged with ILF that outcome payers initially appear more receptive to ILF than transaction managers. ILF does present the benefit of enhancing the impact-creating value of funds deployed such that transaction managers who are independent of funders or otherwise impact-driven and flexible with their expected returns are expected to more readily adopt ILF. For transaction managers required to pursue market-related returns, it may be helpful to find a partner who is willing to pay for impact, such that ILF transactions can be structured with risk allocated accordingly while still incentivising additional impact creation (Patton Power, 2021).

2.4.3 Limiting factors facing transaction managers

Baic et al. (2019) categorise the constraints that potential transaction managers in ILF likely face by: experience, knowledge, attractiveness, capacity, and data.

Regarding experience, the nascent state of the concept and its nomenclature aligns with a lack of awareness of the characteristics of ILF. Many actors will wait until ILF has built a successful and effective record in delivering impact as well as attractive risk-return profiles relative to existing solutions (such as blended finance). Further, there is limited academic research to inform implementation practices, particularly as they overlap with related financial strategies.

Regarding knowledge, it is necessary for actors to have a strong understanding of ILF, its instruments, processes, and implementation practices, and it is made more complex to achieve this understanding given the lack of commonly agreed-upon principles and implementation guidelines. Structuring an ILF transaction involves various trade-offs, for example setting incentives that are not so big that impact enterprises are encouraged to game the system, but not so small that they fail to incentivise additional impact, which are essential to get right to maximise the opportunity for the instrument to be effective (Patton Power, 2021). There have been several developments in practice leading up to the establishment of ILF, such as shifting focus to outcomes from outputs and recognising impact enterprises as the key value creators, which may be unfamiliar to potential ILF transaction managers.

Attractiveness should be experienced by all stakeholders in an ILF transaction, which necessitates a delicate balance between transaction and impact verification costs, deal structuring timeframes, appropriate risk-return profiles, and achievable impact incentives.

Much like the challenges in the impact investment world, impact enterprises suitable for impact and financial additionality may be scarce.

Capacity constraints apply to resources, such as limited expertise for ILF structuring or limited capacity to expand business operations to incorporate ILF.

Data constraints are a well-known concern in impact finance, as particular impact and financial data are necessary to analyse an impact enterprise's business model and structure an ILF transaction. When available, such data may be too costly or time-consuming to obtain to proceed with a transaction.

Baic et al. (2019) note that the above constraints are not exhaustive. Where transaction managers also act as outcome payers, they may face internal and external regulatory constraints where the innovations of ILF do not align with tax incentives, for example. Conversely, where charitable donations form part of a structure, there may be positive tax effects.

2.5 Review of Empirical Literature

A few key studies were identified that considered ILF specifically. These studies are uncommon and practitioner-led, focusing on conceptual exploration of ILF, case studies, and the potential of ILF to mobilise capital for better impact. Practitioner reports to date are notably driven by reputable financial institutions other than Roots of Impact and the SDC as creators of the concept: BCG (Baic et al., 2019), the OECD (2019b), the Esmée Fairbairn Foundation (Buckland et al., 2021), Root Capital (Naeve, 2022), Dalberg Global Development Advisors (Hornberger, 2023), the SDC (König, 2022), the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH (Bauer & Hollmann, 2018) and the UN Capital Development Fund (Choritz et al., 2018); the latter two discuss SIINC's in publications as they pre-date ILF. The research broadly poses ILF in a positive and promising light, with limited insight into criticisms of ILF, for which primary data collection is expected to partly fill the gap.

The lack of academic literature on the subject restricted consideration of ILF theory in section 2.3, and the conceptual framework presented drew on the literature reviewed; thus, it is beneficial to consider the theory in Section 2.3 together with this literature review. The remainder of the literature reviewed is drawn from similar financial strategies that have been established for a longer period.

2.5.1 Enabling: Mission-aligned by design

Transaction managers for ILF transactions are typically responsible for selection and structuring of transactions on behalf of the outcome payer (Baffioni & Crisci, 2022). When considering the organisations best suited to acting as ILF transaction managers, it is relevant to consider transaction managers of catalytic capital, particularly organisations with impact and financial expertise, and a degree of active interest in innovative financing instruments.

Buckland et al. (2021) position philanthropic outcome payers, capital facilitators (trusts, foundations and non-profit investors), and DFIs as key supply-side ILF actors as they are best placed to tolerate reduced returns for impact. Additionally, ILF can be complementary to grantmaking where an organisation is targeting scalable impact enterprises in addition to charitable, non-market-based organisations. However, the report notes that ILF is a complex practice to consider facilitating for many grantmakers, even where they have impact investment experience, as ILF sits between different practices, cultures and mindsets commonly assumed in grantmaking or impact investing. Thus far ILF has been implemented by philanthropic funders already actively engaging across the spectrum of impact finance strategies.

Wishlade and Michie (2017) find that there is a growing interest in the use of financial instruments by the EU's grantmaking bodies due to perceived sustainability benefits of repayable instruments, particularly where sources of funding are constrained. This perception is being actively encouraged by the European Commission, which included the recommendation to its fund managers to double usage of financial instruments, pursuant to the Investment Plan for Europe, due to the capital reflows and fees that financial instruments benefit from, as opposed to grants.

Nyikos et al. (2020) found that, in Hungary, the use of financial instruments correlates more strongly than grants to advanced productivity and economic growth, and Monfret (2019) documented that in 2018, EUR 22.1 billion had been committed away from grants to financial instruments.

For transaction managers engaged in fund management excluding grants, there are typically two sources of income for funds targeting risk-adjusted market-based returns: a management fee and a carry cost. Fund managers that are not primarily focused on financial returns, might also receive an impact carry as remuneration (Izzo, 2013), and there is ongoing research into impact-linked compensation to this end (Patton Power et al., 2024). These narrow channels to

remunerate fund managers for impact limit the benefits of ILF adoption for fund managers, however their engagement is needed for ILF to reach substantial scale.

Buckland et al. (2021) notes that impact investing funds have been less active in ILF due to the capital constraints of their funder mandates, however they discuss various ILF transactions where transaction managers – impact investors and philanthropic organisations – cite the mission-focused merits of ILF as their motivations for applying it, and this therefore constitutes an enabling factor to an unknown extent.

2.5.2 Enabling: Attractive to outcome payers

Most literature surrounding ILF speaks to the benefits to outcome payers. More broadly, the Impact Bonds Working Group (2022) (IBWG) is formed of leading international development funders, financiers, governments, and other enablers of social and development impact bonds. They highlight a stronger need than ever to rapidly mainstream outcomes funding approaches, such that philanthropic funders pay only for impact results and the private sector is drawn in to meet the steep cost of achieving the SDGs.

Much of the growth ILF has experienced thus far has been driven by progressive outcome payers partnering with ILF intermediaries and transaction managers in pursuit of direct impact creation (Buckland et al., 2021; Kwon et al., 2022). In fact, the Michael and Susan Dell Foundation (MSDF) is credited with implementing the first impact-linked debt instrument to incentivise school operators in India to reach better education outcomes using an interest rate rebate incentive. With the investment, it was observed that had the borrower achieved the maximum impact outcomes incentivised, the principle and an 8.3% interest would still have been recovered, and they were simultaneously able to reach more schools and students than if the same amount had been spent with a traditional grant structure. A key factor of MSDF's success was finding an on-the-ground partner in India with a last-mile network that shared their impact objectives. This partner received the impact-linked debt and went on to lend to schools with the same incentive structure (Rangwala, 2018). ILF is a powerful draw on outcome payers, and transaction managers are necessary across market sectors and regions to facilitate ILF transactions. Transaction managers may thus seek to supply the demand of outcome payers, enabling adoption of ILF. Buckland (2021) cautions that ILF transactions to date have been demonstration projects, and that it is unclear how much or how fast outcome payers will scale up this practice.

Still, ILF's conceptual focus on outcomes is relatively novel. International donor and philanthropic funding currently focuses overwhelmingly on impact activities and outputs, rather than resultant outcomes, with less than 1 percent of annual foundation giving going towards results-focused innovative finance projects. This is attributed to inflexible traditional programming, avoidance of costly evidence usage, and standardised approaches being favoured over context-specific solutions; the latter of which aligns with ILF. However, Hornberger (2023, p. 181) points out, "as long as we keep monitoring and measuring our success based on the activities delivered, there is no incentive to maximise for impact." Thus, outcomes funding is critical to more effective donor and philanthropic spending.

Patton Power (2021) notes that grantmakers looking to move towards utilising financial instruments, might find financial instruments other than ILF to be more accessible, such as recoverable grants. These allow grantmakers to broaden their spectrum of financial returns, while utilising existing grantmaking knowledge with less complexity, at least relative to private equity investments.

2.5.3 Enabling: Limited financial trade-off

As discussed in section 2.3, ILF is an important financial solution where an impact enterprise faces a short- or mid-term trade-off of financial performance to deepen its impact creation. This happens where financial performance is not aligned with impact performance, but where an impact enterprise can be expected to achieve a level of scale or adjust its strategy to target specific customer segments (for example, lending to women for microfinance organisations), such that in the short-to-medium term, impact and financial performance are anticipated to align (Patton Power, 2021). ILF can be useful in this scenario to support an impact enterprise to achieve this scale or alignment of performance, as well as benefits such as impact additionality or financial additionality where private investors may be attracted to the enterprise.

Deals with these characteristics are prime for ILF investment and are likely more present in some sectors than others, although this will only become apparent and enabling for transaction managers as the ILF track record grows. To date, studies on ILF implementation generally affirm the use of ILF with positive results when available. To this end, Bronsoler (2020) found that SIINC had had a causal effect on the increased impact additionality of Clínicas del Azúcar without impairing its ability to attract customers from less impactful yet commercially stronger segments. Naeve (2022) found that SIINC created a measurable impact for Root Capital, its borrowers and smallholder farms over the project's two-year term, by making market-

correcting payments to incentivise Root Capital to accept the additional cost and risk of funding early-stage agri-SMEs. Buckland et al. (2021) documented fourteen mini-case studies of impact-linked investments with transaction managers citing reasons for adopting ILF over other instruments including donor interest, mission alignment, the ability to close market gaps, and aligning interests between all stakeholders. Lastly, Boggild (2021) highlights that the use of ILLs provides transaction managers with more options to manage the trade-offs over risk, return and impact.

From a different angle, the IBWG reported that outcomes-based funding structures proved to be most resilient to the COVID-19 crisis, as the programs were particularly adaptable, able to find solutions quickly, able to continue services, and deliver outcomes. This success was such that the IBWG observes that 30% of the funding pipeline is being allocated by members to impact incentive and pay-by-results instruments in 2022, and 24% to public-sector run outcomes funds, as opposed to impact bonds or guarantees (IBWG, 2022).

2.5.4 Limiting: Experience

Per the conceptual framework in section 2.3, experiential limiting factors encapsulate a lack of awareness of ILF, an insufficient track record, and a lack of theory on ILF, all related to the nascent, early stage of ILF.

Baic et al. (2019) and Buckland et al. (2021) have referred to a lack of awareness of ILF and lack of common language around the concept. This is not unique for an innovative financing mechanism, as Andersen et al. (2019) notes this is the case for blended finance, which is more commonly established than ILF. A lack of common language and terminology, given the diversity and highly tailored nature of blended finance and ILF transactions alike, limits the ease with which clear foundations of an ILF market can be built.

Potential ILF actors lack awareness of current ILF transactions' benefits, mechanisms, and experiences across geographies. For private investors, there may be an aversion to engaging with financial solutions that involve the public sector, and in some cases, the need for an independent intermediary has been identified for bringing together different sources of capital (Baic et al., 2019; König, 2022).

Despite the lack of awareness, Buckland (2021) finds that actors, once introduced to the concept, intuitively grasp ILF's value for reducing the cost of capital of impact enterprises, and for providing impact and financial additionality. While various pilot tests and small-scale transactions are taking place, there are limited large-scale ILF facilities.

While the track record of ILF has been developing since inception of the concept – as well as experimental attempts to include impact-links in financing structures for decades before this – Buckland (2021) notes a lack of standardisation regarding how and when to implement ILF due to the early stage of the market, with case studies displaying a range of possible approaches and perspectives of ILF. Market growth is being driven by outcome payers and intermediaries; notably as of 2019, impact-based incentives have been added to a guidance note to the OECD DAC Blended Finance Principles (OECD, 2019a) and SIINC now forms part of the OECD Policy Framework for Social Impact Investment (OECD, 2019b). Baic et al. (2019) agrees that ILF needs to prove that it can be more successful and effective than existing solutions in delivering impact and attractive risk-adjusted financial returns.

Baic et al. (2019) also writes that academic research is limited for ILF, particularly about its overlap with blended finance, impact investing and RBF, or how to optimise financial incentives to avoid market distortion or gaming the system with too high incentives, or missed impact creation with too low incentives.

2.5.5 *Limiting: Knowledge*

Building on the experiential limiting factors above, there is a distinct lack of suitably skilled and experienced ILF personnel, from which transaction managers can draw on to enter the market. ILF requires a departure from previous modes of impact finance thinking, specifically a shift from focusing on outputs to outcomes, a shift towards market-based ILF recipients, a shift to recognising and treating impact enterprises accordingly as the central value creators in an ILF transaction, a shift towards enhanced rigour of impact incentive structuring, and practitioners need to understand these and have the language to accompany it (Baic et al., 2019). Together with the complex elements of ILF transaction structuring discussed below relating to attractiveness as a limiting factor, the growth of ILF expertise amongst transaction managers is a necessary component to scaling ILF.

2.5.6 *Limiting: Capacity*

This area of limiting factors is driven by potential transaction managers. Burton (2020) fittingly observes that improving the impact outcomes of impact enterprises is limited by the limitations of those administering the investment. Per König (2022), there are few organisations globally that have the capacity and skill to effectively design, structure, and monitor ILF transactions and support the impact measurement and management (IMM) of impact enterprises, starting from data collection. The GIZ observed that internal leadership play the crucial role of aligning

internal ecosystems towards impact creation, which can be done utilising smart incentives to affect internal change, and that this would determine the firms that become pioneers of incentivising impact (Bauer & Hollmann, 2018).

Transaction managers hold knowledge on the instruments they currently work with, making it preferential to continue exploiting the same skills and knowledge, rather than engaging new strategies. Even where ILF is seen as sufficiently attractive by transaction managers, constraints on operational capacity, management capacity or expertise may limit their ability to adopt ILF (Baic et al., 2019).

Further, transaction managers exert significant influence over the structure of an ILF transaction and its impact incentives. Should there be a conflict between actors on how impact outcomes are prioritised, the efficacy of the transaction at hand is at risk. To illustrate, if an impact enterprise is driven to create impact in a way that it had not done previously using financial incentives, this may lead to mission drift relating to other impact targets that sit with the enterprise. The onus is thus on transaction managers to regulate the power they wield in structuring transactions, by placing emphasis on supporting and partnering impact enterprises to achieve their impact objectives, instead of directing impact enterprises on actions to take or prioritising standardisation between transactions (SDC & Roots of Impact, 2016).

2.5.7 Limiting: Regulatory

Transaction managers noted particular challenges when implementing a transaction in a region for the first time. When the MSDF implemented the first impact-linked debt in India, caution had to be exercised around the strict laws and regulations in place for investors and grantmakers. This entailed obtaining clearance for the product from the Reserve Bank of India and ensuring expert accounting guidance was provided to the recipients of the ILL (Patton Power, 2021). In some regions, regulations disincentivise or prevent public or philanthropic grantmakers to fund market-based enterprises (König, 2022).

Easing this challenge for MSDF was the availability of established practices around other variable-rate loans that lawyers and auditors could use to gain comfort (Patton Power, 2021). This mitigating factor may reasonably be assumed to have become more prevalent as ILF instruments have entered new markets for the first time, although it will be present until ILF has penetrated the hardest-to-reach markets.

2.5.8 Limiting: Data

Rangwala (2018) highlights that the term “impact” is often used in impact finance circles, however it is unclear exactly how much positive impact is actualised from impact investment or similar financial strategies because the most applied financial mechanisms do not explicitly reward or measure it. The data limiting factors consist of the demands of ILF for impact and financial data on prospective investees, as well as the time and cost associated with obtaining that data. This data is necessary for evaluating potential ILF investments, for structuring impact incentives, and later for measuring and reporting on outcomes (Baic et al., 2019) – moreover, Roots of Impact (2020) cites a good IMM practice as key for enterprises preparing for an ILF transaction. The time and cost associated with obtaining impact data is not limited to impact measurement, but extends to impact verification.

ILF inherently requires the high degree of IMM associated with outcomes-based impact incentives (Buckland et al., 2021). This presents the task of implementing an IMM system to impact enterprises, which is often the responsibility of transaction managers. ILF intermediaries, such as Yunus Social Business (2023), and collaboratives like Biniyog-Bridhhi (2023), have emerged to support impact enterprises in this respect and to take part in the industry-building around ILF. Designing and negotiating impact incentives to align with impact data that is measurable at an affordable cost remains an important challenge for ILF transaction managers.

The MSDF found that successful ILF transactions require clearly defined, measurable, and objective impact metrics. Impact measurement costs cannot exceed the reward paid out, which requires awareness of the cost of measurement of potential impact metrics to inform incentive design (Rangwala, 2018). However, as König (2022) points out, there is often a lack of data available on target impact enterprises necessary for designing effective incentive structures in line with ILF.

Buckland (2021) suggests that ILF may be more suitable for mature impact enterprises, as they are prepared to be involved in the co-creation of ILF transactions as equal partners with strong existing impact data and an ability to shoulder the associated risks. The need for and ease of access to impact data may also differ between sectors of investment, depending on the perceived correlation of outputs to outcomes, although literature is not available in this regard.

Although the cost of impact verification is typically paid for by outcome payers and carried out by an independent third-party (Patton Power, 2021), transaction managers are required to

coordinate and take responsibility for impact verification reporting to outcome payers (Baffioni & Crisci, 2022). Currently, the cost of impact verification is driven up by a lack of suitably skilled impact verifiers in developing countries targeted by outcome payers, and the industry around impact verification is one that is fast developing in its own right (Baic et al., 2019).

2.5.9 Limiting: Attractiveness

ILF was designed to pursue a fair deal for all stakeholders to impact finance transactions. Consideration is given to the level of incentives that will produce the desired results, how to avoid market distortion, and how to align interests between outcome payers, investors, impact enterprises, and the end customers on which an impact is intended. All the while, ILF aims to centre the key value creator – the impact enterprise – in a transaction and retain the conceptual simplicity surrounding the financial strategy (Baic et al., 2019).

Structuring a transaction to achieve all the above is based on relatively simple principles, but in practice presents several complexities, which increase with the number of stakeholders involved. Transaction managers are primarily responsible for aligning interests in this way for each transaction while keeping transaction costs at a reasonable level. Should a transaction fail to achieve the impact envisioned, or underperform against an expected financial return (whether market-rate or capital preserving), this may indicate poor structuring such that outcome payers lose confidence in the transaction manager. Thus, at this nascent stage, individuals responsible for structuring incentives require an in-depth understanding of ILF and structuring support.

The risks of poor structuring are many, however there is no empirical evidence as to the significance of each risk beyond the perceptions of impact finance stakeholders. When MSDF first introduced their impact-linked debt internally, some concern was expressed that an incentive scheme may be manipulated by enterprises to game the system for financial benefits. This added a layer of complexity to design of the incentive scheme. However after the transaction ran its course, MSDF saw no evidence of fraudulent attempts to manipulate outcomes and identified that the size of the reward should not be so big that it encourages gaming the system. Instead, educators whose outcomes were being measured displayed eagerness to improve their outcomes, for which TA could be provided, and the additional layer of complexity built in to protect data collection for impact measurement only served to cause confusion amongst borrowers (Patton Power, 2021).

Buckland (2021) notes that initial concerns expressed by potential ILF actors around the complexity of ILF may be misguided as they do not consider the ability of more mature impact

enterprises to comprehend and cater to ILF instruments. However, it is maintained that there are significant learnings to be had regarding the design, negotiation, and verification of impact incentives, and the pricing thereof.

2.5.10 Recommendations identified from existing literature

Recommendations speak broadly to making ILF more well-known and building a track record to inform and attract transaction managers and other actors.

Relative to the limiting factors identified, Baic et al. (2019) proposes a roadmap hinged on five key levers to scaling ILF, which are described below. All five key levers are currently in motion, albeit at an early stage, driven and designed by capacity-building intermediaries and interested outcome payers.

In response to limiting factors around experience, knowledge, and regulations, ILF must showcase proof of concept (relative to competing methodologies) with its growing track record; continue to engage further stakeholders to build a community of practice; and a specific recommendation is made to create an academic initiative to promote independent research.

To address the limiting factors around experience, capacity, and attractiveness: simple, powerful, and efficient ILF solutions should be developed; and sector-specific pooling should be introduced to reduce transaction costs and realise synergies. The former recommendation would rely on development of support services to provide coverage of the full investment process. The latter recommendation can be done by creating sector-specific pooled funds to target SDGs and stimulate ILF market growth. To this end, Roots of Impact, the SDC and Acumen have published a blueprint for such a fund in off-grid clean energy (Roots of Impact et al., 2018). Baic et al. (2019) envisions a future where a family of ILF instruments is available for all financial solutions with rewards for positive impact built into financial instruments across all asset classes.

Addressing the limiting factors of knowledge and attractiveness, it is recommended to better establish ILF language by building an identity alongside open standards for practice. This has commenced with the introduction of ILF design principles documented in section 2.2, which are expected to develop with the industry and as academic theory emerges, as well as the provision of a detailed ILF glossary amongst other educational resources on the ILF Open Platform (ILF Fund, 2024). Buckland et al. (2021) reiterates the need for terms and framing to be as simple as possible for optimal communication between actors.

In response to limiting factors of knowledge and capacity, ILF actors must actively disseminate knowledge and undertake capacity-building, and Baic et al. (2019) recommends this be done through an open knowledge platform hosted by a group representative of different stakeholder groups. The platform should provide educational resources, particularly for transaction managers, and ILF capacity-builders have begun doing this with platforms such as the Social Finance Academy, which provides knowledge support for intermediaries and TA providers, and Biniyog-Bridhhi, a Bangladesh-based ILF capacity-building program (B-Bridhhi, 2022; Roots of Impact, 2023c). Both programs make available educational resources in the form of written guidance, videos and training programs. Another example of such a platform may be the OECD DAC Community of Practice on Private Finance for Sustainable Development, which hosts relevant educational resources and publications, as well as biennial events to bring together key stakeholders (OECD, 2023).

Last of the five levers, to address limiting factors around experience, data, and attractiveness, it is recommended to leverage technology as it advances over time to support the ILF industry with insights on market and price discovery, and enhance efficiency of IMM and verification, amongst other support. ILF should continue to iterate on its solutions as technology and the market advance. The GIZ further recommends that increased transparency along the value chain of impact investments will nurture IMM innovation, in turn towards greater impact transparency and, hopefully, accessibility (Bauer & Hollmann, 2018).

Baic et al. (2019) also references other social innovations from which recommendations can be derived for scaling ILF. First, potentially valuable insights derived from inclusive finance, or microfinance, include pooling of funds to access classes of institutional investors and improve the efficiency of transaction costs and activities; developing principles for ILF that define the scope of the innovation and guide ethical considerations; and leveraging technology to drive down transaction costs and broaden access to ILF products. Second, learning from the Fairtrade certification, which provides financial incentives to agricultural exporters to meet social and environmental standards, includes leveraging public and private partnerships to drive visibility and establish minimum standards, and introducing premiums and access to non-financial resources such as networks and expertise, which improves commercial viability for certified enterprises.

2.5.11 Limitations to existing literature relating to the research problem

Existing literature is in low supply due to ILF's early stage of growth. Only one quantitative research report specifically regarding ILF has been identified, and qualitative research is limited to evaluating ILF as a concept for efficacy and promise. There is a gap in research on how transaction managers may receive the concept of ILF based on their circumstances, incentives, and perceived availability of ILF implementation; on the overlap of ILF with blended finance, impact investing, and RBF; and on the optimisation of impact incentives, amongst various other specific research focus areas (Baic et al., 2019). Existing literature largely heralds the benefits of ILF with the intention of disseminating information on the concept in a capacity-building effort. Documented criticisms on ILF are limited as the market is a niche of innovative finance with few experienced actors, such that investigation into the experiences of all stakeholders and market landscape as capacity builds would be valuable contributions to the literature.

Chapter 3: Methodology

3.1 Introduction

This chapter documents the research approach and design determined to be most appropriate to gain an in-depth understanding of the research problem outlined in Chapter 1. The outcomes of this methodology are employed to develop the theoretical contribution discussed in Chapter 2 for the benefit of ILF capacity-building actors.

3.2 Research Approach

To address the research questions, the multiple perspectives of transaction managers globally are of interest from an ontological position. Considering the substantial limitations in existing literature discussed in section 2.5.11, particularly regarding such perspectives, and the exploratory nature of this study, a phenomenological research approach appears most fitting to obtain a “fresh, complex, rich description of phenomena” (Finlay, 2013, p. 172). Exploratory research is particularly suited to topics that have not been extensively studied, to allow for discovery of new insights and deeper understanding of the phenomena under investigation. Thus, the study aims to interpret the meaning of participant perspectives and the findings of the empirical analysis through a qualitative exploratory methodology. The nuanced relationship between transaction managers and ILF, as interpreted from descriptions of transaction managers’ experiences (Creswell, 2009), is expected to be impacted by the background and sectoral focus of transaction managers, their knowledge of ILF and how they could reasonably expect to interact with ILF at varying distances into the future. This approach aligns to the goal of capturing the complexity and depth of transaction managers’ experiences and the emergent themes that can inform future research and practice.

3.3 Research Design

3.3.1 Population and unit of analysis

In identifying the stakeholder groupings best positioned for ILF adoption, this paper seeks to encompass the diverse perspectives of potential transaction managers of ILF. ILF being purpose-built for enhanced impact creation and as a catalytic capital strategy is expected to lend itself to catalytic capital providers, such as impact-first investors and philanthropic grantmakers, encompassing family offices, foundations, or corporate foundations (Leijonhufvud et al., 2019). However, corporates are not included in the sample as they lack understanding of the impact enterprise ecosystem and the skills demanded by the ILF framework (Liu & Nowack, 2024). ILF may also be a complex practice for grantmakers to

adopt given their limited participation in innovative finance strategies, however for grantmakers funding scalable impact enterprises, this skills gap may be overcome for the benefits of incentivising additional impact creation, shifting grant funding into a more catalytic role and capitalising on recyclable financial instruments while paying only for verified impact outcomes (Buckland et al., 2021; Wislade & Michie, 2017).

The skill demand is significant as it builds on recent advancements in impact finance, such as shifting focus from outputs to impact outcomes, in addition to the inherent complexities in designing incentivisation structures for specific investees in the absence of commonly agreed-upon principles and implementation guidance (Patton Power, 2021). As a result, expert advisory firms may be engaged to structure ILF transactions and as such they are included in the sample where advisors specialise, or have an interest in specialising, in ILF structuring.

Impact investors applying large ticket sizes in pursuit of ESG opportunities that may not yet be catalytic capital providers are also eligible for sampling, as ILF is considered well-suited for investment in mature impact enterprises (Buckland et al., 2021). This is contextualised by the limited incentives for impact fund managers to adopt ILF that diminish its likelihood (Izzo, 2013), as discussed in section 2.5.1, however the magnitude of ILF scale that may be unlocked by a limited degree of impact investor adoption necessitates their inclusion in the sample.

The study therefore applies transaction managers operating between impact investing and philanthropic grantmaking, inclusive, as depicted in Figure 3 and discussed in section 2.4.1 (being impact investors, grantmaking foundations or philanthropies, and advisors involved or interested in transaction implementation), as its unit of analysis, without a geographic focus to mirror the borderless nature of ILF investing discussed in section 2.3. The institutions were represented by senior personnel as key informants able to represent their interests and experiences. Such transaction managers are anticipated to be best positioned to adopt ILF in their practice as the market scales, given their familiarity with impact methodologies and, for some, investments that accept concessional returns. This diversity of inputs is intended to provide a holistic perspective of transaction managers' relationships to ILF, such that deeper insights can be gleaned from the contrast of perspectives.

At present, there is no list of global transaction managers to serve as a population. Accordingly, a sample frame has been compiled from practitioner reports and the resources of impact finance intermediaries. Transaction managers have been selected from the resulting list by applying the sampling technique detailed below.

3.3.2 Sample selection procedure and sample size

Considering the lack of an available population database to create equal opportunities for any transaction manager to be selected, probability sampling is not feasible. Therefore, the research design pursues non-probability sampling and accepts a degree of sampling bias.

In cooperation with Roots of Impact, the organisation that conceptualised ILF and its design principles, expert sampling is applied. The Roots of Impact professional network was utilised to find suitable sample units with some familiarity with ILF. The remainder of the sample included transaction managers unfamiliar with ILF found through desktop research. This entails purposive sampling to strategically select samples from which a rich source of information is expected to provide unique insights into the research questions (Patton, 2015).

Given the highly nascent ILF market, few organisations exist with the capacity and skill for effective structuring and monitoring of ILF transactions (König, 2022). Furthermore, ILF transactions to date have largely been demonstration projects (Buckland et al., 2021). The objectives of this study look to understand what may limit or enable transaction managers' decisions to adopt ILF and therefore it is relevant to collect data from transaction managers that are best positioned to adopt ILF, and are representative of all positionalities on the adoption of ILF while the market landscape is still taking form: those who have adopted the practice, those who have expressed interest in ILF adoption, and those who are unfamiliar with the strategy but are positioned well for its adoption based on the review of empirical literature and theory discussed in sections 2.4-2.5. As such, thus transaction managers were carefully selected for alignment to the objectives and requirements of ILF, despite their level of familiarity with the concept, in order to ensure the sampling of information-rich cases (Patton, 2015).

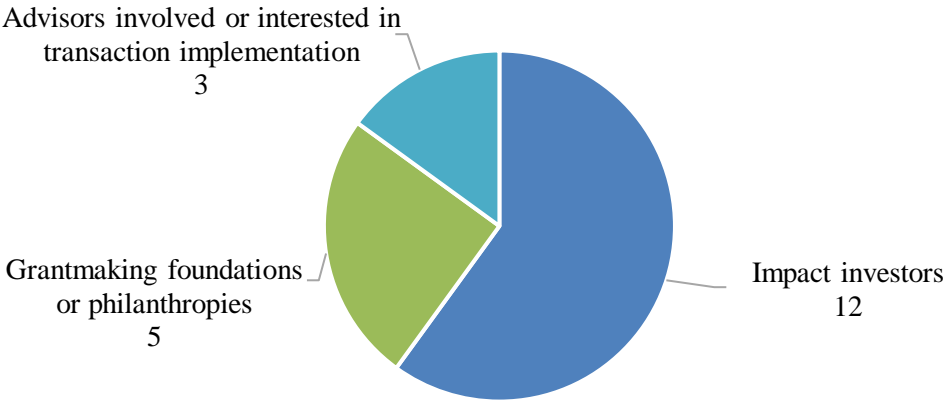
Data collected from the sampled transaction managers is applied to in-depth analysis of phenomena with respect to the research questions. The nature of this analysis, specific scope of the research questions, and volume of data sourced from each sample suggest that a small sample size is appropriate (Leacock et al., 2009). Conversely, the open-ended geography of the study and the lack of established theory on the subject call for an increased sample size. Lincoln and Guba (1985) generally recommended a sample size between 12 and 20 for this research approach.

Similar academic studies are observable in neighbouring fields of finance such as impact investment, blended finance, and RBF, but not in ILF. Academic studies applying similar qualitative approaches use an 18-26 range of sample sizes (Bennett, 2019; Habberton, 2019;

Solwa, 2019; Struwer et al., 2022), with doctoral studies at the latter end. Practitioner reports that applied sample sizes in the range of 25-30 participants were funded studies conducted on a larger and extended scale than this proposal.

Therefore, a sample size of twenty financial institutions and foundations was determined. The sample would not benefit from sufficient scale to yield generalisations about transaction managers' relationships to ILF worldwide, however an undertaking is still made to obtain a range of responses from the major profiles of transaction managers. Figure 4 shows the distribution of the sample between stakeholder groups. Refer to section 4.2 for further details on interview respondents.

Figure 4: Stakeholder groupings sampled



Source: Author's illustration

3.3.3 Sources of data and data collection instrument

Primary data for phenomenological research is most often collected with interviews, and as such this study adopts this data collection instrument to provide the depth of information needed to address the research questions. Using a cross-sectional time horizon, data was collected by the researcher asking the respondents questions via an online video call using a standardised set of questions.

The standardised questions are derived from the assumptions underlying the enabling and limiting factors identified in Table 2 (the conceptual framework) using the interview protocol refinement framework of Castillo-Montoya (2016). This four-phase framework supports the quality of data obtained from interviews and is simply broken down as follows. In the first phase, interview questions were built around the research questions, using the conceptual framework and literature review findings. In the second phase, an interview guide was

developed from the interview questions in an inquiry-based conversational style, which involved simplifying the terminology used, structuring the interview guide in a rational order that observes the social rules of conversation, and determining key and follow-up questions. In the third phase, feedback on the interview guide was obtained by consultation on the interview questions with experienced peers and close reading of the aspects of interview protocols: structure, phrasing, length and comprehension. Finally, phase four involved piloting the interview guide with an individual who possessed the relevant characteristics of the interviewees. Learnings from phases three and four were used to amend the interview guide structure and phrasing, particularly to ensure that all questions used open-ended wording to enrich responses and limit researcher influence.

The interview guide (see Appendix B) addressed the following areas for data collection: understanding the institutional background, such as fund mandates, financial instruments in use, and interactions with innovative financial mechanisms; understanding the interviewee's knowledge base with respect to ILF; then focusing on perceived limiting and enabling factors relative to ILF, exploring details on these factors; and finally interviewees were requested to provide recommendations to industry-building actors on how their engagement with ILF may be facilitated.

3.3.4 Data collection procedure

Data collection in the form of in-depth, semi-structured interviews over Microsoft Teams took place from 24 October to 15 December 2023. This was preceded by ethical clearance approval by the UCT GSB Research and Ethics Committee on 19 October 2023. As such, a verbal exchange took place by which a prepared list of questions was asked, however there was scope for the interview to be conversational. This allowed the interviewer to provide clarity on the meaning of questions and follow up for more detail to foster clarity when interpreting the meaning of answers. Language around ILF was simplified and took the lead of the language used by interviewees, clarifying on meaning where necessary, to prevent miscommunications due to the lack of established terminology around ILF. Interviewees also explained their experience and perceptions of the matters and were able to direct conversation to areas which they deemed most relevant regarding their relationship to ILF.

Data quality with the proposed structure is hinged on the skill and knowledge of the researcher, which may impact the comparability of findings. The risk of this is mitigated by the pre-formulation of interview questions (Bryman & Bell, 2011) with guidance from Roots of Impact.

3.3.5 Data analysis process

Collected data was conceptualised into multidimensional constructs for comparison and synthesis. Constructs included the degree of involvement with and attitude toward innovative financing mechanisms and ILF in particular, the list of limiting and conversely enabling factors that interviewees perceived with respect to the adoption of ILF, and the list of recommendations for scaling ILF penetration.

Thematic analysis of interview responses was applied to aid conceptualisation and to identify patterns for interpretation of findings, as described in the framework of Castro et al. (2010). Verbal responses were coded to relevant groupings and categorised by themes following a thorough analysis of the meaning of the coded groups.

3.3.6 Validity and reliability

To ensure a high degree of confidence in the methodology, data and findings of this research, five criteria were reviewed and applied. First, the “credibility”, or the internal validity and confidence that can be placed in the research findings. Second, “dependability”, or the consistency of responses such that they could be observed by another researcher applying the same methodology over time. Third, “confirmability” refers to demonstrated neutrality such that research findings are unbiased by the researcher and would be consistent with another’s independent interpretation. Fourth, “transferability”, or the external validity and applicability of findings to other settings (Guba, 1981; Lincoln & Guba, 1985). Fifth, “authenticity”, which relates to the rigorous detailing of descriptions to fairly capture diverse realities (Lincoln, 1995).

Inherent to the interpretivist nature of this study and this application of non-probability sampling is an unavoidable degree of bias. Contributing to this inherent bias, the author of this study was contracted on a part-time basis to Roots of Impact for work unrelated to the study during the research period and received access to their professional network and guidance on the interview questions as documented in sections 3.3.3 and 3.3.5. This relationship introduces particular biases as follows, in addition to those discussed in the sections above: interpretation bias, leading to interpretation of data that favours company interests, alongside cognitive confirmation bias related to company perceptions; and social desirability bias that may influence interviewee responses to align with the interests of Roots of Impact (Nikolopoulou, 2023), where a professional relationship is present.

The following measures were applied to ensure findings are of a high standard despite the personal style of data collection and the influence of Roots of Impact, based on the strategies

of Shenton (2004) and Connelly (2016). First, to support the “credibility”, audio recordings of interviews have been taken and transcribed, in addition to interviewer note-taking; and findings were supported through data triangulation, which involved gathering information from transaction managers of diverse backgrounds, across geographic regions, levels of seniority and different types of transaction managers, spanning impact investors, foundations, and advisors; to allow for the emergence of an holistic view of the phenomenon despite limited consensus in respondents’ perspectives. To support “dependability”, a detailed research protocol has been maintained and documented above. Following data collection and analysis, documentation was updated with how the methodology was carried out for added transparency. The consent form template and interview guide are retained for subsequent inspection, and the assigned research supervisor has provided an appraisal of the research process and outputs. To support “confirmability”, the sample covers institutions from various backgrounds, extending beyond the professional network of Roots of Impact, with responses triangulated to reduce researcher bias. A detailed audit trail was also kept throughout the study. Contextual detail about data collection instruments and the methodology applied relative to that was provided to support “transferability”. Details of the period over which interviews take place, the duration of interviews, the individuals interviewed, and the selection criteria for interviewees were all provided in section 4.2. “Authenticity” is supported through an elevated level of detail about participant responses with notable quotations highlighted in the report for a fair representation of the realities communicated.

Chapter 4: Discussion of findings

4.1 Introduction

This chapter presents and discusses the data collected through semi-structured interviews. First, the group of respondents is described with context on how respondents were oriented towards ILF. Thereafter, specific themes are explored following the structure of the research questions per section 1.2, starting with the enabling factors that increase the use of ILF, which provides the necessary basis to then discuss the limiting factors (loosely following the structure of the conceptual framework in section 2.4) preventing ILF adoption by transaction managers and implementation capacity in the broader ILF market. Respondents' perceptions of enabling factors going forward, per the research objectives in section 1.3, are presented at the end of discussions on the respective limiting or enabling themes. The chapter concludes by offering a visual summary of the factors identified in the primary data collection process.

4.2 Overview of respondents

The twenty qualitative interviews were conducted over video calls as the transaction managers were distributed over Europe (9), North America (4), Africa (3), South America (3) and Asia (1), with a 60:40 split of men and women, and most respondents investing internationally. The respondents were distributed over each of the stakeholder groups identified as positioned to adopt ILF to obtain balanced and representative findings. Table 3 provides a profile of the respondents interviewed. Refer to Appendix C for their placements on the impact investment spectrum, noting how most enterprises span multiple strategies, which is indicative of the borderless nature of the impact investment spectrum.

For the most part, respondents' organisations did not fit exclusively into classifications of grantmakers, impact investors or advisors. None of the grantmaking foundations or philanthropies solely focused on grantmaking, with two impact investors and two grantmaking foundations or philanthropies actively in the process of diversifying their investment activities away from grantmaking. This phenomenon is discussed further in section 4.3.2.

On average, the respondents had 10.4 years of experience in impact finance with eighteen holding senior positions in their organisations. This provided the benefit of learning about organisational decision-making, as well as the thinking of impact capital professionals who are mobile between different impact finance organisations based on factors such as fund structures and interventions that align with their impact objectives.

Table 3: Respondent profiles

#	Stakeholder grouping	Organisation type	Position	Years of impact finance experience	Orientation to ILF	Continent	Date of interview	Duration (mins)
1	Advisor	Impact finance advisory firm	Acting Chief Executive	10	Implementer	Europe	24-Oct-23	60
2	Impact investor	Impact investment firm	Investment Principal	13	Exposure in practice	North America	24-Oct-23	36
3	Impact investor	Impact investment firm	Managing Partner	16	Aware	South America	26-Oct-23	62
4	Grantmaker	Public-private development partnership	Chief Executive Officer	18	Implementer	Europe	27-Oct-23	67
5	Impact investor	Impact investment firm	Founder & Chief Executive Officer	14	Implementer*	North America	30-Oct-23	53
6	Impact investor	Impact investment fintech	Chief Financial Officer	7	Exposure in practice	South America	02-Nov-23	58
7	Impact investor	Impact investment firm	Executive Director	14	Aware	Africa	07-Nov-23	57
8	Grantmaker	Impact investment firm	Chief Executive Officer	6	Unfamiliar	Africa	07-Nov-23	61
9	Impact investor	Impact investment firm	Senior Associate	4	Exposure in practice	North America	09-Nov-23	53
10	Impact investor	Impact investment firm	Founder & Managing Partner	12	Exposure in practice	Europe	10-Nov-23	50
11	Impact investor	Impact investment firm	Impact Investment Manager	7	Implementer	Europe	15-Nov-23	55
12	Impact investor	Impact investment firm	Investment Director	11	Aware	Europe	17-Nov-23	54
13	Grantmaker	Philanthropic foundation	Investment Executive	4	Aware	Europe	21-Nov-23	60
14	Impact investor	Impact investment firm	Co-Founder & Managing Director	10	Implementer*	South America	28-Nov-23	56
15	Impact investor	Impact investment firm	Investment Director & Head of Lending	12	Unfamiliar	Europe	29-Nov-23	55
16	Philanthropy	Impact accelerator	Innovative Finance Consultant	5	Aware	Europe	29-Nov-23	52
17	Impact investor	Impact investment firm	Executive Director	7	Aware	Europe	04-Dec-23	59
18	Grantmaker	Philanthropic foundation	Head of Programmes	5	Aware	Africa	07-Dec-23	55
19	Advisor	Philanthropic foundation	Country Director	26	Aware	Asia	13-Dec-23	62
20	Advisor	Impact finance advisory firm	Vice President	6	Unfamiliar	North America	15-Dec-23	56

Noted: Column “Orientation to ILF” gives context to the discussion of findings in sections 4.3-4.4, as follows: ‘Implementer’ indicates that the respondent has structured at least one ILF investment*; ‘Exposure in practice’ indicates involvement in ILF transactions in other capacities that implementation (e.g. participation in a pooled fund); ‘Aware’ indicates that a respondent has been introduced to the concept of ILF previously; and ‘Unfamiliar’ refers to respondents who were unfamiliar with the term “impact-linked finance” at the time of the interview. * Respondents 5 and 14 implement impact-linked investments, although these do not fall within the definition of ILF per section 2.2.4.

4.3 Enabling factors

This study explored the enabling factors experienced and perceived by transaction managers in deciding whether to adopt ILF, at present and going forward. Thematic analysis revealed that ILF adoption is enabled by three aggregate dimensions, or overall patterns in the second-order themes identified: relevance of ILF for the transaction manager's circumstance, suitable funding availability, and the transaction manager's outlook on innovative finance and impact creation. These dimensions are re-oriented from the conceptual framework (section 2.3).

4.3.1 *Relevance to transaction managers*

An important prerequisite to all other factors explored is the *relevance* of ILF for a given transaction manager. Several respondents described understanding ILF in the context of a continuum of financial instruments developed for impact. Based on a transaction manager's goals, resources and the needs of the enterprises they aim to support, transaction managers follow a decision tree-like process of identifying whether traditional finance products are sufficient or if innovative finance instruments are relevant to them. Then identifying which instrument, within the world of innovative finance, is most suitable given the myriad enabling and limiting factors being investigated in this study.

"I don't think impact-linked finance is the right tool in every instance." (R13)

Based on this decision-making process, transaction managers may identify ILF as suitable for their purposes or not. However, Respondent 1 highlights the reality that transaction managers are often in a position of information asymmetry regarding the continuum of innovative finance, which is a consequence inherent to nascent and at times esoteric spaces such as this:

"I think organisations often struggle [with] how best to match a need with a specific solution. There is a lot of merit in working with a third party to help them understand the whole of the market, the whole opportunity set, rather than very quickly engaging in a conversation about a specific fund that they want to set up because they've heard that others are doing it or a specific DIB or a specific impact-linked finance transaction even." (R1)

This section therefore relates to the necessary alignment of ILF for transaction managers' purposes, encompassed by the sub-themes of *investment strategy compatibility* and *portfolio company alignment*. Relevance is considered enabling as a determinant of transaction

managers' adoption of ILF, however it is not an actively enabling lever of change or systemic influence as the other factors discussed in this section.

a) Investment strategy compatibility

Transaction managers' decision-making is made within the bounds of the fund mandates, trust deeds or shareholder expectations that apply to them.

"We try and be as innovative as we can, but specifically on the social side of things, we are bound by a mandate, right? Because we have a trust deed. And all investment businesses will have their PPM [Private Placement Memorandum] or their LP agreements, right? And so that will give you a specific mandate and if you're bound by those mandates, that could be a constraint." (R8)

"It's an evergreen structure ... and we can just decide among the shareholders if we want to change the investment strategy, but of course, the more shareholders we get, the more difficult that gets..." (R10)

Depending on the stakeholders involved, respondents report constraints on the type of instruments that can be applied or the terms they can offer due to shareholder or LP agreements, or conversely being contractually obligated to provide concessional funding by philanthropic funders with specific impact goals or approaches in mind. In some cases, the requirement was to implement ILF. From a compliance perspective, Respondent 4 (a non-profit) noted that they would need to be able to evidence reinvestment of funds received on investments that expect any type of financial return to protect their non-profit status.

Given the bounds on transaction managers' investment strategies and other limiting factors discussed in sections 4.3-4.4, the simplest route to ILF may be for funds to be purpose-built for ILF provision, as "it's easier ... to start from day one" (R5). However, the availability of this option is limited by additional constraints that outcome payers put on young funds or new fund managers, which are biased towards more vanilla fund structures:

"Because we're early stage ... all our LPs said no leverage. And then we're also not allowed to recycle capital, which is also pretty common in traditional private equity fund, or venture capital funds. And so we have a very conservative structure." (R3)

Transaction managers are also guided by their impact mission, such as poverty alleviation, renewable energy transitions and so on, in selecting an investment strategy. ILF appears to be broadly applicable across impact themes, although further insight on this would be valuable (section 4.4.1).

Transaction managers who are willing and able to accept risk to prioritise impact are particularly aligned with ILF as catalytic finance (Baffioni & Crisci, 2022). Similarly, this is the case with transaction managers whose objective is to stretch the impact of their capital by paying only for impact created. As an example, Respondent 7's use of a convertible grant to recover funds for impact not achieved aligns well with impact-linking. A review of appendices C and D together demonstrates where ILF sits on the impact investment spectrum and that many respondents align with the positions of ILF on this spectrum, taking into consideration that the sample was selected to be distributed over groups considered to have potential to adopt ILF.

b) Portfolio company alignment

Transaction managers who align with ILF's bottom-up and enterprise-centric (Baffioni & Crisci, 2022) in the impact space, as opposed to ESG, appear to be growing, and moving away from philanthropic grantmaking towards financial instrument usage. Four respondents are currently shifting strategy toward investment in philanthropic ventures and commercial interventions using instruments other than grants:

"We're now seeing organisations that have come from a venture philanthropy background who are looking to experiment with new models. And in some cases setting a carve-out for repayable finance." (R1)

A key reason for this shift is the objective to create sustainable impact through sustainable business models:

"If capital isn't the problem – because there is capital – then how that capital is used may be the problem. And capital needs to be used in a way to create longevity of impact, and that is created by investing in quality opportunities that [have] a level of sustainability to them that just keeps on ticking without the need for further funding, because if that further funding doesn't come then impact is curtailed." (R7)

"We want to invest with a social outcome in mind, or have a commercial business linked to a social business where the outcomes or the profits from

the commercial-linked business will then feed the social business and make sure that it remains sustainable.” (R8)

Others cite supporting portfolio companies’ long-term prospects of attracting commercial capital:

“Up until now, we were only able to support them with grants. ... Oftentimes, it’s not good for the enterprise to just be grant-funded. They need to build a track record of repaying liabilities.” (R16)

In this way, the interests of commercial capital providers influence impact investment strategies:

“The reality is more often than not, the impact investing space grows but attracting commercial capital is often an end goal as such.” (R13)

Thus, there is an ongoing trend of impact-focused transaction managers shifting focus to investment in impact enterprises, and moving into a space where ILF is a particularly relevant strategy.

Amongst transaction managers investing in market-based organisations, respondents noted that ILF is impractical for high volumes of investments, where firms cannot spend time with individual enterprises to develop tailored financial solutions for them. In the same vein, replicability of instruments is often a priority, as a respondent described of their prior experience with ILF:

“The KPIs [Key Performance Indicators] were ... very specific to that entrepreneur. And there’s one, two other entrepreneurs in LatAm [Latin America] doing something similar. So if you want to make it replicable, you can go to those two other entrepreneurs, but that’s where the plan ends.” (R6)

This was particularly the case where transaction managers are required to disburse large sums of money or where a high volume of low-growth impact enterprises is being targeted (as opposed to highly scalable opportunities). The latter objective would not align with ILF, which particularly targets ventures expected to be scalable to commercial viability (B-Bridddhi, 2021).

Respondent 14 found that the relevance of ILF for short-term investments appears to depend on the transaction manager holding long-term relationships with portfolio companies:

“We came with the idea of the model that was already there of sustainability-linked or impact-linked loans, and we decided to use it ... but in a context of a long-term vision. So when we work with these organisations, we agree to work for the long term – at least five years. ... And what we do basically is use these short-term loans as small milestones that will add up until we achieve those larger goals.” (R14)

In contrast, Respondent 2 said the following when asked whether they would implement ILF in the future:

“I don’t think so because of the short-term bridge nature of our loans. It doesn’t necessarily provide a good fit, but never say never.” (R2)

From an enterprise-centric perspective, respondents were drawn to ILF as it provides a reduction in cost of capital to investees as an effective reward to the value creators on the ground. Respondent 11, an active ILF investor, noted that entrepreneurs were “relatively happy” with the investments they received as they were able to pursue the impact objectives that were the reason they started their businesses in the first place, although they would prefer a shorter and smoother investment process.

c) Going forward

At a systems level, some respondents indicated that innovative finance is necessitated by complex environments, such that transaction managers and other system actors would experience a push towards more innovative financing approaches, which is a necessary step in the direction of ILF adoption.

“We are always looking at introducing innovative finance, right? Because in South Africa in particular you’re dealing with a very different kind of social innovation entrepreneur. ... There’s so much need – more than you know – and there’s some market failures in the space, ... so it requires innovative ways of solving those issues, but you can’t solve those issues with the same kind of funding mechanisms or traditional mechanisms in place. ... The complex environment kind of necessitates an innovative way of financing those who are willing to be on the ground solving some of these issues, right? ... There’s nothing stopping us from introducing more and more of those innovative approaches in future.” (R18)

Lastly, transaction managers are subject to asymmetric information on investments strategies across the impact investment spectrum and their place within the spectrum. Together with awareness-building (section 4.4.1), market-builders and innovative finance consultants can play a role in improving ecosystem co-ordination by supporting transaction managers in identifying relevant strategies based on their objectives, the impact enterprises they target and constraints on their investment strategy.

4.3.2 Funding

This section discusses sub-themes related to funding as enabling for ILF adoption: access to concessionary funding with which ILF transactions can be implemented, exposure of transaction managers to pioneer ILF outcome payers, and the sustainability of ILF and other repayable financial instruments as draws to adoption.

a) Access to concessionary funding

When asked what would best facilitate adoption of ILF by transaction managers, the foremost response was more available funding, particularly from funders that align with the objectives of ILF and transaction managers. Most respondents, when asked, stated that the interests of capital providers had a material influence on their investment strategy. The remainder takes an approach of clearly communicating their investment strategy upfront for capital providers to either opt in to or not. One respondent explained that they face the threat of mission drift without strong alignment and transparency with funders, but that they have only been able to find such alignment with one funder through their shift from grantmaking to impact investing as a well-established institution. A respondent seeking concessionary finance found that although outcome payers were interested in innovation, the highest priority remained financial returns.

“What we've seen is that there is an interest because it's something innovative and they, of course, like to hear something new. ... But we haven't seen too much interest on ‘oh, I want to invest’ or ‘I want to provide general capital to develop this idea or to learn more’, right? ‘How to use this, how to improve it, how to scale it up.’ And at the end, the conversations go to ‘what kind of returns are you paying?’ And unfortunately, we've seen that even [from] so-called catalytic investors or investors that provide catalytic capital. They are expecting market-rate returns at the end.” (R14)

Flexibility driven by transaction managers' fund structures in the context of concessionary finance was a key theme. Flexibility, a core element of catalytic capital as defined, enables transaction managers to test and develop new strategies, such as ILF:

“There’s a huge opportunity to explore and develop and see how you could modify the tools or have new tools, but you’ve got to have donor appetite to be open to doing that and failing as part of that, and I don’t think that exists today.” (R4)

Respondent 1 (an advisor) agreed with the opportunity Respondent 4 refers to, however they and another respondent pointed to foundations as providing this opportunity in the form of grantmaking to transaction managers:

“What we’re seeing increasingly is that there are typically NGOs that have foundation partners who are really sophisticated or who are looking for something that is more innovative and less business-as-usual to support. So they’re actively saying to these organisations, what can you show me that’s a bit more exciting that I haven’t seen before that I could consider for support, as opposed to a standard grant-type request? And there I think is a really good example where organisations are missing an opportunity to take advantage of a funder-led interest in their business to engage in impact-linked finance, and often with a partner that is sufficiently catalytic in their approach, that they can do this almost as a pilot, as a proof of concept, inevitably make some mistakes along the way, using a relatively small sum of capital. And then if that’s successful, then there’s a great opportunity to scale that up, to replicate it, to build on that first successful model.” (R1)

Philanthropic grant funding for concessionary¹ investing was cited as a driver of concessionary investment strategies several times, enabling transaction managers to structure their investments around what is best for the particular venture or sector, often accepting outsized

¹ “Concessionary” is the dominant terminology for reference to capital that accepts below-market rate returns in exchange for impact, however one respondent expressed notable disdain for the term, in line with opinions expressed by industry personalities (Boland & Boland, 2023). When one considers the inevitable financial, societal or environmental impact of any investment, it becomes apparent that all investments are concessionary in some way, however the terminology functions to place financial returns on a theoretically-baseless pedestal.

risk and simultaneously providing non-financial support. While some respondents with young funds reported difficulty in raising such philanthropic grant funding, others credited a reputation associated with innovative finance implementation as enabling for grant fundraising. For respondents expected to provide market-rate returns to their investors, philanthropic grant funding is sought to enable innovative finance adoption potentially as a sidecar:

“If you can get the foundations or the venture philanthropists or the government to make grants for ILF, then you can impact enhance without compromising returns, so then it would be very suitable for the for-profit commercial impact funds that exist.” (R10)

Or by internally blending market-return and concessionary sources of finance:

“The final product for the blended finance becomes very concessional because the other capital that we bring into it has zero or negative interest rate. So that’s how the product becomes more concessional for the entrepreneur, but we have very limited room in order to move the interest rate of our capital, because we do have that obligation to our traditional investors to repay.” (R6)

Respondents pointed out a lack of availability of this type of funding from DFIs and other public funders, who are considered critical to scaling ILF per Buckland et al. (2021). Respondent 4 (a public-private development partnership) noted that in general, DFIs look to fund more mature impact enterprises, if any, than the early-stage and growth-stage enterprises that ILF is best suited to. Another DFI-funded respondent explained that DFIs apply only a small fraction of their funding to innovation, often through innovation labs but not filtering that into their mainstream activities, making it difficult to raise funds from them despite their innovation arms pushing results-based financing as a strategy. More commonly, DFIs expect market-based financial returns as well as strong impact performance. Another respondent experiences that DFIs are unlikely to provide grants to for-profit impact investors, because of a risk of creating unfair competition in the market, and complex regulatory environments (the example given was of EU rules) that prohibit subsidisation of profit by DFIs.

Another way respondents were able to flex the financial instruments in their toolbox is through investing from their own balance sheet, whether they are trusts or family foundations with large endowments, shareholder-funded with evergreen structures, or receive large-scale donations as

philanthropies. This positioned the transaction managers to be responsive to gaps in the market, in one case to the extent of incubating and launching a venture debt fund independently.

b) Exposure to pioneer outcome payers

Most respondents who had ILF implementation experience had done so through a partnership with the SDC, which acts as a pioneer outcomes payer (Baffioni & Crisci, 2022). The proportion of ILF implementers partnered with the SDC should be considered together with sections 3.3.3 and 3.3.7; the purposive sampling approach taken posed bias towards the professional network of Roots of Impact, which overlaps with that of the SDC, as co-developers of ILF.

Reviewing the nature of those respondents highlights that market-building actors seek out impact-focused transaction managers with demonstrated innovative finance capabilities and access to relevant impact enterprises to grow ILF implementation capacity. Respondent 1, an innovative finance-focused advisor, was receptive to this strategy:

“I would love to see actors such as the bilaterals and multilaterals, start to pump the primes ... and help to build this market, even if it means a lot of [subsidies] initially, to be able to demonstrate the viability of these models.”

(R1)

This enabling factor aligns with the enabling nature of catalytic funding discussed above, however as Respondent 4 pointed out, pioneer outcome payers are made by their leadership:

“Swiss Development Corporation [SDC] is leading in this area, and it has more to do with the individuals involved.” (R4)

Thus, the magnitude of this enabling factor may be linked to market-builders’ ability to mobilise industry leaders to drive ILF innovation, particularly those able to finance the high transaction costs associated with ILF, as noted by Respondent 6 and discussed further in sections 4.4.3 and 4.4.5.

This enabling factor is a useful lever of change for market-builders, however Respondent 5 cautions against reliance on it and puts the ball back in the court of transaction managers to drive innovation, as noted at the end of section 4.3.1:

“Most funds begin by asking the questions: what do my investors need? Or my potential investors? Perhaps they have a close connection with the

Rockefeller Foundation or with USAID. And so they start with that as the question of, okay, I know who I'm going to approach as an investor, what do they need? I think that is absolutely the wrong way to approach this work. I think the right way to approach this work is to ask what does the world need, and then decide if you can fill some of those needs? And so we always begin with the question 'What do social enterprises need that are reducing poverty?'" (R5)

c) Funding sustainability

On the flipside of the flexibility that comes with balance-sheet investing, respondents (including ILF implementers) expressed numerous times that finding ways to recycle their funds, such as through making repayable investments rather than grants, was a driving factor in which investment strategies they adopt.

For some, there is a need for their grantmaking to become less donor-dependent to avoid having to continuously divert resources to fundraising. And Respondent 7, also donor-funded, added that:

"If you don't have a significant endowment, you need to look at where you are best-placed for other opportunities; that the longevity of impact is not just there." (R7)

Respondent 14, who invested off of their balance sheet until recently obtaining philanthropic grant funding, noted that they could not afford to provide grants, but still wanted to directly promote impact, so they adopted ILF as an efficient means to recycle their capital through repayable instruments. Respondent 5, who applies a similar balance-sheet funded ILF strategy, notes however that there is "financial pain" in absorbing the concessionary elements of their funding, particularly when the timing of impact-linked discounts is not spread over the investment period. This aligns with Respondent 15's comment:

"The biggest constraint is just equity within social investment firms. So ourselves and all our peers are just poorly capitalised." (R15)

In other cases, respondents noted that they were mandated to demonstrate capital preservation despite providing concessionary capital, necessitating the implementation of repayable instruments.

d) Going forward

Two respondents believe that increased use of pooled funds would increase targeted impact funds flow and make ILF more accessible, as recommended by Baic et al. (2019). A pooled fund that implements ILF across different impact themes could provide a more efficient allocation of philanthropic funds at scale. This mechanism would address the deficits created through siloed impact investment spheres and the information asymmetry around the range and appropriateness of instruments, as it lowers the burden placed on fund participants. This reduces the need of participants to invest transaction costs, have operational capacity or internal expertise to implement ILF. This approach has the added benefit of providing broad exposure of ILF to transaction managers. The ILF Fund for Gender Inclusive Fintech was used as an example, which takes a targeted, or pooled, approach by providing ILF funding and TA to fintechs sourced from the portfolios of prominent impact investment funds, rewarding gender transformation outcomes (ILF Fund, 2023b).

Three respondents identified a system trend over recent years of traditional philanthropies introducing and embedding innovative finance into their impact strategies. Not only does this validate innovative finance in the broader philanthropic world, but it is expected to increasingly mobilise large-scale sources of philanthropic funding towards strategies such as ILF, as practitioners seek to enhance the efficiency with which they deploy funds for additional impact. Interestingly, two respondents singled out transaction managers as being uniquely positioned to drive adoption of innovative investment strategies, highlighting a role for transaction managers to play in market-building for ILF and other innovative finance strategies by identifying its relevance and advocating to outcome payers:

“I think a lot of the donors – many of them aren’t leading. ... They’re really following and so they’re looking to us to say, okay, what instrument is best.”
(R4)

“We as the fund manager, we are kind of an intermediary between the LPs and the investees. It’s kind of up to us because we are the centre of it. We can see, we can find what is needed, if that makes sense. The LPs don’t necessarily understand what is needed because they’re kind of more remote from the actual investees.” (R12)

Lastly, a respondent taking a systems approach to impact creation values interventions that can be implemented by local transaction managers in the Global South where they target impact, as they have identified that local adoption of interventions is critical to moving the needle on the

SDGs. Therefore, market-building efforts should incorporate a focus on building implementation capacity where impact is being targeted.

4.3.3 Transaction manager outlook

This section discusses sub-themes related to the aggregate dimension of transaction manager outlook. Transaction managers' orientation towards innovative finance and their commitment to their impact objectives were identified as creating necessary alignment for ILF adoption.

a) Innovative finance orientation

The majority of the respondents with ILF implementation experience are branded in some capacity as innovative finance experts, with at least two inspired to implement ILF off of social or development impact bonds, which took the innovative finance world by storm in the 2010s:

“It was so difficult to implement our development impact bonds that our thinking was: we need to find something really more easy to implement... After researching and talking with some people, we came with the idea, but we didn't have any experience implementing ... exactly impact-linked finance ... before we started so I guessed it was for us, we'll trial and error ... at the beginning.” (R14)

ILF exists at the innovative finance frontier. As a respondent noted, professionals engaging with ILF need strong impact finance knowledge, having made some shifts in thinking around impact theory (for example, moving from impact outputs to impact outcomes, or from Measurement & Evaluation to IMM) that are not yet necessary for professionals in more established impact investment segments. In some cases, transaction managers take responsibility for driving these thinking shifts in the market:

“We're even trying to shift our investors, our donors to think that way... It's an advanced way to think, right? And not everyone is thinking that way.” (R20)

Another recurring theme pointed to advanced investment structuring as fulfilling at an individual level:

“There is a tendency to overcomplicate it and, in my view, I think in the blended finance space in particular, there's a lot of finance professionals,

including myself, who enjoy the structuring and the innovation in it all...”

(R13)

In line with this, the respondents without ILF implementation experience who can be described as innovative finance experts had generally positive outlooks on it, although not without concerns, and other respondents expressed interest in joining co-investment ILF structures for the innovative finance learning opportunity. It therefore appears to enable transaction managers interested in adopting ILF to be open to and engaged in innovative finance in some capacity.

b) Pursuit of impact goals

Perhaps the most self-evident, this enabling factor relates to transaction managers' pursuit of high-quality, sustainable impact to push the needle on the SDGs as enabling for ILF adoption. This is the primary reason given by respondents who have implemented ILF for its use, and other respondents who had experience with outcomes-based contracts described incentivising impact outcomes as an effective way to enable impact enterprises to prioritise impact with transparency while learning how best to achieve outcomes:

“It's [outcomes-based contracts] obviously got some really good aspects to it, which is the measurement. ... It forces the delivery to be done in a really transparent way and allows for some pretty in-depth analysis of what works and what doesn't work.” (R15)

Notably, those incentivising impact with the terms of their investments independently of the influence of ILF pioneers (section 4.3.2) are implementing adapted ILF variations as they followed their own paths to impact-linking concurrently with the SDC and Roots of Impact in recent years. In addition to the enabling factors above, the parallel routes to impact-linking are underscored by the central objective of rewarding impact:

“We do that [impact-linking] because our definition of a successful investment is one that repays and has big impact. And so, of course, we should reward that.” (R5)

At a systemic level, too, transaction managers are invested in the prospects of impact-linking:

“I think impact-linked loans are quite a good starting point, both for borrowers and for investors, and to get into the habit and practice of linking impact and financial returns, I think is something that's going to dramatically

shift this market and mean that capital is allocated to where it's most impactful rather than to organisations that have the strongest voice or a charismatic founder.” (R1)

The prioritisation of impact over commercial returns, which is a feature of all catalytic capital providers to varying degrees, should thus point transaction managers supporting market-based organisations to ILF in some capacity.

c) Going forward

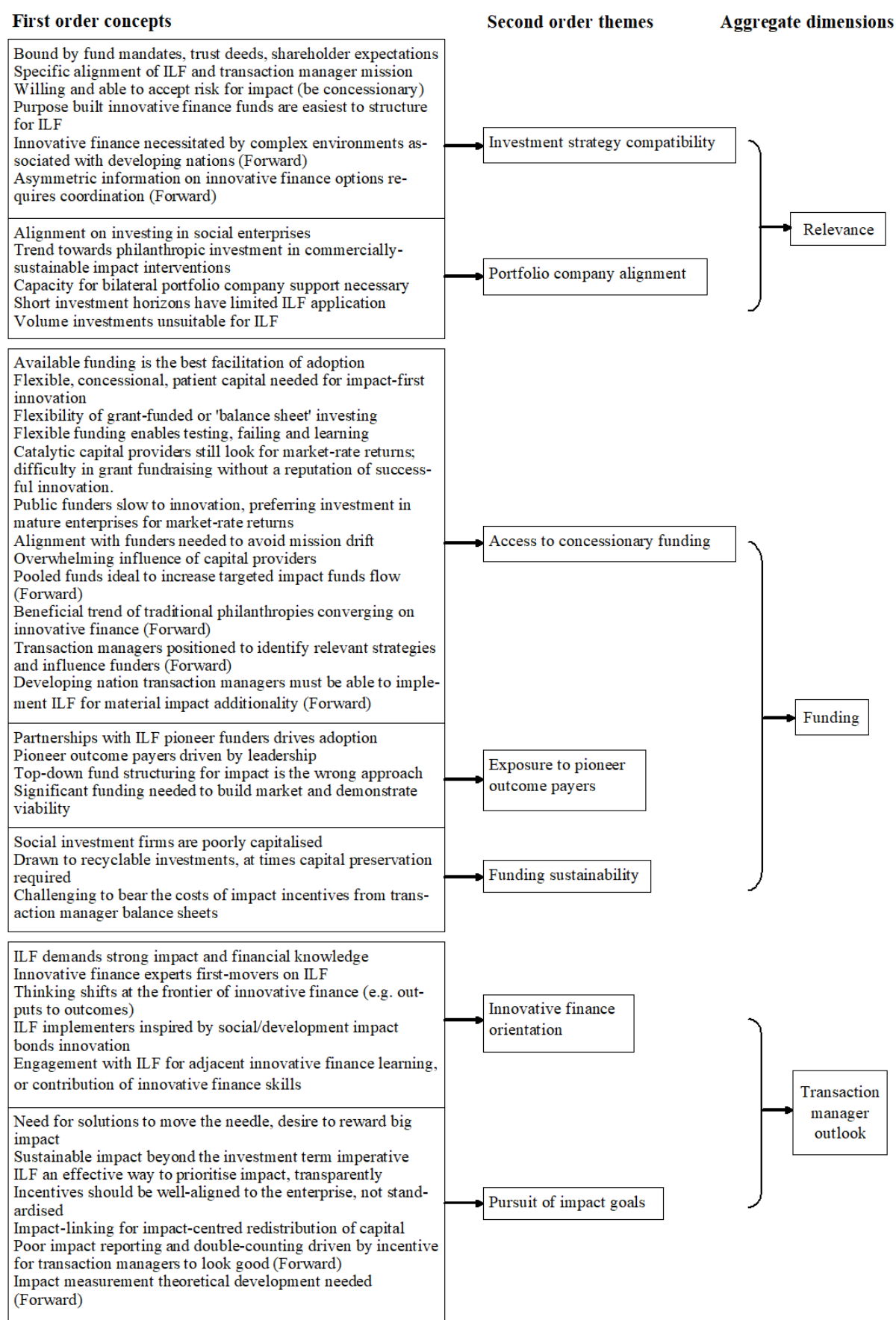
It was noted that transaction managers face incentives to look good publicly and to partners, but to conceal failures:

“There [are] incentives in place to look for impact metrics for volume to show success, [when] that’s not necessarily the case. I would say there’s a lot of double-counting going on of impact metrics. ... The reality is a lot murkier and nuanced and grey...” (R13)

ILF mitigates for this issue through its rigorous application of impact verification and cutting-edge IMM practice, however a potentially beneficial focus area with the growth of the impact measurement space (section 4.4.4) would be the development of methods to allocate impact to transaction managers in a meaningful way, such that transaction managers are engaged to contribute more directly to impact creation, such as through ILF. Such methods would benefit from consideration of how to measure impact creation beyond an investment period, as transaction managers are interested in impact data from past partners to inform their impact strategy, particularly where they invested at an early stage.

The data structure related to factors enabling of ILF adoption are presented in Figure 5.

Figure 5: Data structure for enabling factors (Source: Author's illustration)



4.4 Limiting factors

This study proposed to explore the limiting factors experienced and perceived by transaction managers in deciding whether to adopt ILF. Primary data analysis renders the following aggregate dimensions as comprising limiting factors as described: available experience of ILF, the availability of relevant knowledge, internal capacity for ILF adoption, impact data requirements and costs, and the attractiveness of ILF as a strategy.

4.4.1 Experience

This section discusses identified limiting factors related to market and transaction manager experiences of ILF: a lack of awareness of ILF applications at a transaction manager, funder and market level; and the related lack of ILF track record.

a) Lack of awareness

ILF adoption is limited by the lack of awareness of the benefits, mechanisms and experiences of ILF by transaction managers, their funders and the market in general. Linked closely to the limited ILF track record at this nascent stage of industry growth, concerns around the applications of ILF limit adoption at various stages of the ILF value chain.

To demonstrate respondents' awareness and interpretation of ILF, they were asked to place ILF on the impact investment spectrum, which is presented in Appendix D. Where respondents were unfamiliar with ILF, an explanation was provided for comprehension; three respondents were unaware of the term. Respondents generally understood ILF to be catalytic capital (Naeye, 2022), mostly identifying it as aligning with impact-first investing, venture philanthropy and philanthropic grantmaking. This demonstrates Buckland's (2021) finding per section 2.5.4 that practitioners intuitively grasp the role and merits of ILF once explained, regardless of whether they were familiar with the terminology beforehand. Five respondents identified that on a certain level, impact-linking is applicable across the impact investment spectrum depending on the specific instrument, but that the high transaction costs associated with ILF, an inability to standardise the processes, and the requirement for financial return concessions, confines it to impact investing and grantmaking spaces, rather than ESG investing.

Some respondents were sceptical about the need for incentivisation of impact in the context of ILF, as there are few long-term case studies to draw on for evaluating the strategy. This echoes existing literature that speaks to concerns around complexity from actors who have not yet experimented with ILF (Buckland et al., 2021). Respondent 17 currently invests equity, grants, quasi-equity and some loans in agricultural impact enterprises where impact objectives align

with financial performance. These instruments suit their needs as the agricultural industry provides many proxies through which to track impact data. In addition, targeted due diligence and screening processes together with highly-involved partnerships are believed to be sufficient to ensure impact creation from investments:

“If I think of the type of investments we make, because we are investing in the model because we are convinced that the model inherently creates impact. [ILF] almost feels like an unnecessary step. ... If in the due diligence, we ...tested that this ... ag-enterprise [produce trader] actually has offtake centres in the rural areas that the farmers can go to and they actually do receive information like on best practices, and they actually do receive better access to market, more stable prices, they get paid faster. ... In their financial data, we can see how many farmers they bought from and what volume they bought. ... And we can kind of see in their business performance how well they did on the impact as well. And there’s a lot of proxies in their financial data like, if we see that their farmer base is growing, maybe even with small marketing, then we could assume that the farmers are actually happy with this ... off-taker relationship. ... Like there’s a lot of proxies in the financial data that I can use to check that they are actually being impactful without needing that whole structure.” (R17)

In another case, long-established institutions of philanthropic grantmaking were noted to have well-developed impact strategies that may not benefit from ILF adoption.

“The preconception was ‘we do 100% impact’ so there is not necessarily the urge to integrate these terms into the term sheet because that’s anyway what we do. If you come from the private sector, you’d be like, ‘yes, let’s do this, because we don’t know whether we do it.’” (R16)

In spite of this, there is a gradual ongoing process of well-established grantmaking philanthropies embedding innovative finance into their structures (section 4.3.1). A respondent whose firm structures investments for Donor Advised Funds referred to the challenge of donors and financial advisors conflating impact investment with ESG investing, particularly for high-net-worth donors relative to very- and ultra-high-net-worth donors and their advisors, giving insight into the scope of education and awareness needed for their donors. While there is no evidence of Donor Advised Funds as outcome payers in an ILF structure as yet, Social Finance

(2019) reports that 72% of such donors indicated that they are interested in making impact-first investments.

Respondents also indicated a process to innovative finance that transactions managers experience, shining a light on the importance of the timing of their exposure to ILF or other innovative strategies. By the time Respondent 9's firm decided to engage with an ILF pooled fund, they had internally identified the importance of the related impact theme, and their unique position to create impact in relation to the theme – effectively seeing both the impact and the business opportunity – such that they had built up interest and capacity to engage. For a few respondents, the COVID-19 pandemic accelerated their process to innovating as it created an urgent requirement for concessionary interventions, often in the form of blended finance structures. For transaction managers transitioning from 100% grantmaking strategies to innovative finance, Respondent 1 advises that it can be a years-long process of learning, engaging with other ecosystem actors, building partnerships and developing an understanding for the forms of investment that best suit their purposes.

b) Limited track record

Transaction managers are looking for specific answers from ILF's nascent track record as to how best to implement the strategy with appropriate risk mitigations. Such track record build-up would enable transaction managers, as well as outcome payers (Buckland et al., 2021), to operate with more confidence. However, innovative finance strategies are being developed to solve issues in impact finance and accelerate its efficacy with urgency; as such, it is not the case that transaction managers will necessarily hold back until the solution is backed by empirical evidence.

“I would say we can go for things before there's empirical data on it if we feel that we have enough clarity on the rationale of the structure, so that we can form an educated or substantiated hypothesis of how this will influence this company. To an extent we have to operate like that. Even the companies that we invest in, they have models often that haven't been tried yet or other people have tried, but no one's gotten the unit economics to work yet. So a lot of our work has to be about: we thought about the model in theory, created a hypothesis on whether this might work or not. And then we act upon that.”

(R17)

From ILF's growing track record, transaction managers are looking to understand the actual versatility of the instruments to incentivise impact in different ways or be applied to different contexts, in line with the findings of Buckland et al. (2021). As an example, Respondent 13 was interested in ILF's capacity to be financially additional, particularly for engaging local capital in developing countries: how the strategy will take form as track record builds, and where the pitfalls are versus the determinants for successful financial additionality.

Another concern that may only be clarified with greater track record is the adverse effect of incentivising impact outcomes for early-stage investments that have yet to establish a commercially sustainable model.

"We invest at a very early stage, and these entrepreneurs need to pivot and change, and trying to settle on a concrete impact outcome when that business model might change is often the difficult piece... Sometimes that can be done in just the pricing; that you almost don't want to over-incentivise either and in the same way that they ... should be pursuing a sustainable model, that might ... conflict with the higher impact in some instances. ... But we would still want most entrepreneurs to focus on the one that's going to prove a sustainable model for them, ... even if perhaps ... at least in the short to medium term that might be deemed lower impact." (R13)

It may be that incentives can be priced to avoid over-incentivising enterprises into an entrenched position that cannot attract commercial capital, however the respondent notes that it can take ten or fifteen years until stakeholders can clearly reflect on an enterprise's path, which is entirely misaligned with investment periods under five years.

c) Going forward

In response to the experiential limiting factors, respondents gave recommendations for ILF market-builders and ecosystem actors on awareness-building, industry communication and dissemination of future learnings from the growing ILF track record.

Awareness-building

Showcasing of transaction managers implementing high-quality ILF transactions can enable market growth by creating excitement in the area and drawing in co-investment and knowledge-sharing opportunities with adjacent impact investment spaces, intermediaries and outcome payers.

“Financial institutions are seldom creative, and most of them don’t like to do new things that have never been done before. So knowing that somebody else has done it, and that it wasn’t very painful, and providing a roadmap of how you could do it, I’m sure would be helpful.” (R5)

Many respondents either suggested or referred to existing tools and case study guidance from ILF experts as being a key source of learning. Further development of such learning materials as ILF experience builds would be welcome, particularly at a greater level of detail. Referring to B-Bridhdi ILF toolkits, a respondent implementing impact incentives commented:

“That was definitely helpful to have ideas and also even that kind of theory about definitions of certain things. ... I think it was too punctual, right? It was all these different instruments, but just a bit of information about each of them. It was good to have the perspective what innovative or impact-linked finance was, but then there was not much to learn from each of them.” (R14)

A popular suggestion was for a database of past transactions, not necessarily with full detail, but with some narrative and guidance on outcome incentives and other experiences from past transactions, stratified by impact theme, sector or business model targeted. A lot of value is placed on on-the-ground experience, and it provides an opportunity to other transaction managers to identify common or related experiences that may be useful in their learning journey. For this reason, and that they are otherwise best placed, the responsibility to generate tools and resources is attributed to Roots of Impact as the ILF pioneer, until the market reaches its next growth stage.

Another tool suggested was tech- or AI-enabled research assistance to support transaction managers in understanding the full impact finance spectrum in detail and to compare strategies in a simple way, which would support informed innovative finance decision-making and reduce the workload for costly consulting services. Currently, many transaction managers cite expert consultancy as the main way to go about adopting a new investment strategy.

Setting up communication channels

Communities of practice, peer exchange and roundtables fulfil several functions for transaction managers: knowledge-sharing and education, promoting ecosystem connectedness, providing opportunities for networking for fundraising, pipeline or partnerships, and even enabling transaction managers to have a voice on industry matters. A respondent went so far as to credit the EVPA (Impact Europe), a major regional impact finance network, with influencing the

public sector to be more open to innovative finance through advocacy and resource-sharing on ILF and other innovative finance strategies.

Such communities are increasingly arranging innovative finance learning sessions, including ILF, and assembling learning resources for members to access, which also functions as advocacy for innovative finance in turn. Additionally, they provide an important platform for knowledge-sharing between ecosystem actors. An asset of the impact industry is higher level of openness relative to more mainstream industries as stakeholders are united by shared goals, which lends itself to learning and market growth through peer exchange. A transaction manager interested in transitioning to ILF should thus be able to engage with relevant communities for learning and partnership-building, as well as to contribute to innovative finance development discussions.

An example of casual practitioner knowledge-sharing amongst a community of 400 regional investors:

“It’s a WhatsApp group, and I’m there purely to watch – not to comment – but every now and again, somebody will go ‘Hey, have you looked at ghost preference shares?’ And I’m like, what is that? Then there’ll be a collaboration around how that’s being [done]...” (R8)

Conversely, respondents emphasised in-person gatherings and smaller communities to build trust and allow more open sharing. For ILF practitioners in the future, there may not be peers nearby as is the experience of other innovative finance practitioners, but having online networks with limited numbers of similar practitioners in other regions has been helpful as an alternative, with the added benefit that practitioners can go so far as to share legal contracts, terms and experiences as they do not operate in the same geographies.

Roundtables on very specific themes, such as ILF, were noted as highly useful for efficient collaboration around an issue. Similarly, targeted opportunities to collaborate and familiarise with ILF in roundtables or working groups can increase the confidence of transaction managers in their decision-making around adoption of ILF.

Respondents investing in the Global South highlighted that these awareness-building activities should be targeted towards transaction managers in developing countries to build capacity of local implementing partners. Often this knowledge-sharing happens at the headquarters of NGOs in the Global North, and the opportunity to upskill on-the-ground implementers is overlooked.

Other than knowledge-sharing, communities of practice are a lever to create cross-sectoral communication channels where the impact investment ecosystem tends to be quite segmented. They provide channels for distributing industry news, although one respondent found it to be important that communities are driven by intermediaries as opposed to implementers or other practitioners, because a community co-opted to market particular organisations will struggle to maintain the focus of community members.

Importantly, respondents valued such communities as essential pathways to bilateral connections and relevant stakeholder groups worth investing in to meet potential fundraising partners, develop relationships to support future pipeline, or otherwise ensure that they have a say on industry matters.

Focus areas for learning from the growing ILF track record

The ILF design principles are evolving on an ongoing basis as its track record builds (Roots of Impact, 2023a). Although “focus on simplicity and transparency” is currently a design principle of ILF, a few respondents expressed interest in finding ways to simplify the most rigorous elements of ILF further to make adoption more accessible for transaction managers and impact enterprises. Others highlighted the importance of adjustment mechanisms in recognition of the volatile realities of growing impact enterprises, or guidance for better alignment of impact verification timelines with the financial amortisation of ILLs.

More generally, transaction managers are looking forward to a greater sense of what works best and when, regarding ILF implementation, from the growing portfolio of ILF experiences. There is hope that such knowledge will make guidance on more standardised approaches to ILF available, for easier implementation processes in the future.

4.4.2 Knowledge

a) Existence of experts

Most respondents with prior ILF implementation experience directly stated that it was necessary to work with Roots of Impact as a third party which had expertise to help with adoption of ILF and structuring of their first transactions. Respondents familiar with ILF were also familiar with Roots of Impact and the SDC’s work pioneering and market-building for ILF, as foremost experts in the space. Beyond the above, ILF as a niche experiences a shortage of well-versed experts that impacts accessibility of the strategy.

“One significant challenge we encounter in the impact-linked finance sector is finding individuals who fully grasp the whole model. It’s a niche area, and onboarding professionals who possess both the technical expertise, such as business and financial acumen, and a comprehensive theoretical understanding of impact incentives is often a hurdle. This can be a setback to greater market adoption of ILF.” (R11)

Working in favour of transaction managers is the increasing number of people moving from traditional finance to impact investment, bringing with them sophisticated approaches to appraising financial instruments. Another respondent noted that the UK impact investment market is well-developed with parallel outcomes-based contract experience from public-private partnerships dating back 20-30 years, such that a shortage of expertise was not a concern.

It is otherwise anticipated that growth in experienced ILF professionals will follow the scaling of ILF implementation capacity.

b) Going forward

The availability of expertise on innovative finance and ILF is expected to grow as the market grows, but respondents expect to remain reliant on external consultants or technical experts to provide training, for example on IMM to impact entrepreneurs, to advise on structuring processes, and to guide investments in specific impact themes to ensure that an inclusive stakeholder approach is taken that maximises prospective impact and risk-adjusted financial returns, where relevant.

4.4.3 Capacity

This section discusses the factors related to transaction managers’ internal capacity that limit ILF adoption, either relating to internal expertise, or operational capacity.

a) Internal expertise

The investment strategy adopted by a transaction management firm depends on its existing expertise, especially if there are experts in a particular field or the organisation has built a brand reputation associated with particular instruments.

“We start with the question, ‘what do social enterprises need?’ And then ask the question, ‘what are we experts at offering?’ And that’s how we determine what we offer.” (R5)

A challenge in ILF is that it requires both technical impact and financial skills, and individuals need to balance both skillsets when there is a tension between them. Insufficient internal expertise for ILF adoption is thus a limiting factor for transaction managers considering ILF adoption.

“In the realm of impact-linked finance, it’s crucial to have a dual focus: a robust grasp of impact assessment and measurement is just as important as a business perspective. Coming from the business side myself, I’ve had to actively seek out and learn about impact measurement, theories of change, and related concepts to gain a well-rounded understanding.” (R11)

A respondent (advisor) gives the example of a large, established transaction manager that wanted to move from grantmaking to an innovative finance strategy. They found that their grantmaking team had no investment background and no knowledge of innovative finance. Hence, it was a long and steep learning curve. However, personnel can develop competence in these skills over time. Other transaction managers have relied on consultant workers to bring in the necessary expertise.

Notably, two transaction managers have research departments that have published reports on areas relevant to ILF. However this research has not been incorporated into either of their investment strategies so much as it has been used to shape investment teams’ understanding and share the knowledge with other industry stakeholders.

b) Operational capacity

The capacity of a transaction manager to undertake a strategic shift was frequently referenced as a barrier to ILF adoption.

At an individual level, humans – whether the investment analyst or the board chairman – do not like change, so it becomes necessary to sell a new strategy internally and think about the incentives for adoption of the strategy that target individuals, in order to ensure alignment between the team. This is essential for team members to take the appropriate course of action to preserve the objectives of an investment when tension emerges between financial and impact objectives. Team members are the ones who will walk the investment journey with impact entrepreneurs, making it essential to have this sort of alignment.

Respondents recalled resistance to blended finance when it was still a new concept by industry peers who were already overwhelmed by their day-to-day tasks. However, after a few months,

individuals had an opportunity to learn by doing and built an appreciation and alignment with innovative finance from the process in that way.

To adopt a strategy such as ILF, transaction managers need a management team who are willing to walk into a new strategy knowing that trial and error will be needed to understand how to get it to work.

“Financial institutions are seldom creative, and most of them don't like to do new things that have never been done before.” (R5)

Innovative finance or strongly impact-driven respondents described continually seeking out opportunities to better achieve their impact goals. The entrepreneurial drive to perpetually innovate is a critical defining factor between transaction managers that can create long-term impact sustainability with their ILF investments, versus those driven by a need for capital who might say yes to any opportunity, as one respondent pointed out. In other words, the willingness and ability to accept the risk of failure to improve investment processes is a key success factor for innovative finance techniques such as ILF. Furthermore, ILF itself is still taking shape as practitioners learn from implementation experiences, so this attitude towards innovation will allow transaction managers to do the hard work of adapting impact-linking to best support the entrepreneur in impact creation and drive ILF forward theoretically.

“You need to have a long breath and stay very passionate and enthusiastic about doing it. Because you need to be there for the longer run.” (R16)

This particularly applies to transaction managers that are well-established philanthropies, as such organisations move slower than smaller or purpose-built innovative finance funds and require more layers of approval.

Per section 4.4.1, there is a process to innovative finance adoption, through which a transaction manager agrees internally on the importance of a new approach and goes on to build internal capacity to embed innovative finance. In one respondent's previous role, their organisation considered linking impact to financial terms, and the primary reason for not doing so was the challenge of incorporating it from an accounting and internal systems perspective, which demonstrated a lack of “ILF-readiness”.

Transaction manager leadership, as practitioners in a young industry, are often fully occupied maintaining various processes and objectives, so the capacity to adapt internal processes and

learn deeply about ILF poses a significant challenge, even for well-experienced individuals. Particularly for grantmakers shifting to new repayable instruments:

"It's been a big adjustment. Obviously, we can't be handing money out recklessly. So we've had to be more stringent and put more rigorous processes in place to be able to manage the risk to an extent." (R18)

Beyond initial adoption of ILF, transaction managers need the capacity to spend more time evaluating the success of investments, not only at a point in time (as the success of a transaction changes over time and with adjustment mechanisms) but also longitudinally, as the industry continues to evolve and practitioners become more sophisticated. The easier path at times would be to justify underperformance of an investment with external factors. Still, rigour is required to learn and respond efficiently.

Respondent 15 also highlighted that it is labour-intensive to maintain close relationships with impact enterprises as is currently considered inherent to ILF, particularly to keep a level of understanding of what is happening on the ground, to ensure that all stakeholders understand the structure and what is expected of them, and to adjust as the program runs in response to learnings. Respondent 7 balances this challenge:

"Any sort of investing is really about how you align with the people that are involved and if you are honest and transparent and really quite clear what your objectives are, it's easy to get that over the line. It might not be quick, but it is effectively easier." (R7)

Finally, on venture funds:

"Venture funds are not nimble. Like they don't have a lot of flexibility to determine what that structure looks like as time goes on." (R9)

Venture firms' LP agreements determine their investment strategy, instruments, transaction quantum, target geographies, over a typical investment period of four-to-six years. These agreements are generally more restrictive than the trust deeds of grantmaking foundations. Regardless of the merits of a new investment strategy, if it is outside of the scope of the agreement, it would take a major shift for a venture fund engaging in thematic investing, for example, to move towards it, presenting a major limitation on operational capacity for transformation.

c) Going forward

Respondents simply recommend allowing more time for traditional finance providers (whether grantmakers or otherwise) to transition fully to ILF, or any other innovative finance strategy. It takes time to upskill or source innovative finance skills, to evaluate what investment strategies are most appropriate, and those strategies will likely require refinement and adaptation to the circumstances of the transaction manager, which at times requires iterative trial and error, amongst various other ILF adoption activities.

In this context, Respondent 1 made the following recommendation for transaction managers considering adopting ILF:

“I think organisations that have the ambition of going on to interact in this market in a meaningful way should start with a pilot investment.” (R1)

This could be done using a small fundraise, implying a small budget, thus a more standardised approach may be needed for feasibility. This approach to adopting ILF would allow transaction managers to experiment and gain confidence about the ILF mechanisms and benefits to see if it is an appropriate fit before proceeding.

ILF adoption and onboarding process support

Those respondents who had implemented ILF through partnerships with the SDC (section 4.3.2) described being onboarded by Roots of Impact, and the informal internal training provided to new joiners. Section 4.4.2 speaks to the challenge of onboarding team members who can understand the whole model with sufficient theoretical and technical knowledge. Given this, future transaction managers would benefit from a process-driven approach for efficiency as implementation capacity scales.

There were two schools of thought between respondents on the matter of investment process support for ILF: those who are exclusively interested in digital systems for efficiency as their practices scale, and those that showed interest in tech-enabled methods to support first-time ILF adopters. The former group preferred learning about ILF and applicable processes through communities of practice or peer exchange. While they were interested in automating transaction processes wherever possible, the technical aspects that differentiated ILF from more traditional investment processes (e.g. needs assessments for TA, understanding the value-add of impact frameworks) are viewed as too difficult to digitise.

The latter group were interested in a process-based digital tool and suggested they would find assistance with the screening, due diligence and structuring parts of the investment process particularly helpful. Respondent 11 noted losing a lot of time in the ILF screening stage when run by new team members, which would be avoided with good screening tools. For due diligence, tools would be helpful to guide which areas of impact to look at alongside drivers of financial performance, which could then be translated into appropriate impact metrics in the structuring phase. Currently, the support needed in structuring is driven by the lack of track record and awareness around ILF implementation, particularly around the type and quantum of outcomes to incentivise for greatest success.

A respondent cautioned that such process support should be in the context of training, due to the complexity associated with ILF as defined:

“The reality of impact-linked finance, as with blended finance, there can be complexity. So this isn’t replacing the current process. This is just targeting those organisations who are newer to the space who need to get up to sort of threshold level, because my view is, there would be a bit of a risk, actually, of opening this up to market participants who are not then subsequently going to embed this in their organisation. ...this is simply part of the training.” (R1)

Such a process-based tool would support an ILF pilot programme well when provided alongside educational resources, to enable transaction managers to implement ILF at an increasingly high level of sophistication.

Transaction workflow management software can provide such support throughout the investment process at a lower cost than advisory services, while allowing for automation where beneficial, and process reengineering as ILF best practice develops (Georgakopoulos et al., 1995). Transaction managers who had sourced workflow management software cited costliness as the biggest hurdle to adopting a digital tool, although this cost would be compared to the savings differential in advisory services. Another challenge is that such investment strategy-related tools are useful as long as they are specifically applicable to transaction managers, as compartmentalised by their strategies. Transaction managers operating hybrid approaches find such digital tools often irrelevant. Moreover, the usefulness of such a digital process tool would be contingent on being able to filter the guidance based on the stage of business being targeted, sector and other key perspectives.

Specific support for the structuring phase of ILF implementation was suggested in the form of systematised guidance on instruments, outcome metrics and other context-dependent elements. This is driven by the lack of ILF track record to date and the helpfulness of case study-based guidance. Some respondents are already investing in research on impact outcomes for their impact objectives, and as information becomes available, this would be useful to access with such a system.

“We have impact consultants come in and they might sit alongside a process and if I was thinking with impact-linked financing in itself, I think it’s a long way from it but ultimately, all sectors...is there an idea of benchmarking or triggering when it does and doesn’t make sense and these kinds of pieces? Is there templates, legals, all these things in place?” (R13)

Lastly, some respondents are open to implementing ILF where they are not the lead investor to learn about the merits and mechanisms of ILF. Respondents point to the mainstreaming of financial instruments linked to gender-based impact outcomes, and emergency financing programmes during the pandemic, as having been good opportunities to be involved in ILF structures peripherally for exposure and learning.

4.4.4 Data

Data – the value and feasibility of better impact data, and that value relative to the time and costs to obtain said data – was a notable limiting factor for several respondents.

a) Impact data requirement

Well-developed IMM is key for an impact enterprise to be positioned for ILF investment, however respondents differed on the value of increased rigour in IMM and verification. This was a point of departure for some applying impact-linking strategies that differ from ILF as co-developed by the SDC and Roots of Impact, and thus the impact data requirement of ILF constitutes a limiting factor to its adoption in full.

“I believe Albert Einstein says that not everything that matters can be measured, and not everything that can be measured matters, and I agree.”

(R5)²

Although challenging, respondents generally appreciate IMM because it is associated with lower perceived risk due to the availability of more information. IMM is also a crucial function of impact enterprises, like measuring financial performance. It transparently drives impact delivery and enables in-depth analysis for strategic decision-making. Furthermore, an IMM system can signal to follow-on investors that an impact enterprise is serious about making a positive difference.

Similarly, respondents value the verification element of ILF as it drives validity of the ILF structure as paying for impact achieved, without which the effects of incentives would be distorted for entrepreneurs. Impact verification is also favoured where transaction managers invest in intermediaries and thus are separate from the impact value creators, to mitigate an over-reliance on assumptions in an investment thesis.

However, respondents differed on the degree of IMM that is necessary for impact incentivisation. Respondent 5 applies a simplified impact incentivisation model that does not require implementation of IMM that did not already exist, or utilise external verification, described further in section 4.4.5:

“The compromise that we're making, is because we can't accurately measure impact, we can't say that one intervention is definitely you know, 7% better than another intervention, but that's okay. ... When you're making \$200,000 loans, which is what we are doing, all of our borrowers are moving the needle, we think they're all doing it efficiently. Maybe there's a little efficiency being left on the table. Maybe we chose the second-best borrower and not the best for impact. ... But we've freed our borrowers to do their work, rather

² For accurate records, the saying, attributed to Albert Einstein with weak evidence, likely stems from a sociology text that is even more appropriate: “It would be nice if all of the data which sociologists require could be enumerated because then we could run them through IBM machines and draw charts as the economists do. However, *not everything that can be counted counts, and not everything that counts can be counted*” (Cameron, 1963, p. 13).

than burden them with all of these impact measurement and requirement responsibilities.” (R5)

This perspective is a limiting factor for adoption of ILF in line with the principles co-developed by the SDC and Roots of Impact. The present lack of empirical evidence as to the extent of the benefit of ILF and IMM rigour makes it such that transaction managers are grappling with making their judgement on the best approach to support impact enterprises – only time will tell.

Respondent 5, who screens investments for well-established, growth stage impact enterprises, finds that impact entrepreneurs are best placed to determine the metrics of successful impact creation with minimal interference, and that self-reported impact data is sufficiently trustworthy for payout of incentives. Others lament the challenge of obtaining impact data they can trust where external verification is unaffordable. The relevance of IMM for impact-linking and the ability to rely on self-reported data may be influenced by factors such as the sectoral or business-stage focus of transaction managers, or the sizing of impact incentive payments.

Much of transaction managers’ apprehension about the IMM and verification requirements of ILF is rooted in concerns that they may cause distraction to entrepreneurs or that impact enterprises targeted for investment are not ready to implement IMM.

Several respondents expressed a desire to avoid overburdening impact enterprises with IMM or, worse, causing mission drift by impact data requirements that become “the tail that wags the dog” (R7). Impact enterprises are fully occupied with running a business and the added complexity of targeting impact, fundraising, and scaling. Thus, when structuring, it is important to strike a balance between depth and simplicity – the latter of which is emphasised as more effective from ILF implementation experience. More specifically, one respondent commented that ILF impact data requirements should focus on the key metrics, and any administrative or checklist-style data collection related to enterprises’ business processes be simplified to a discussion at most, as the collection process for management teams becomes lengthier and more disruptive than the data is worth.

The impact data requirement of ILF is also limiting in that impact enterprises that could benefit from impact-linking funding are not always prepared to implement rigorous IMM practices. Like the process to innovation for transaction managers in section 4.4.1, impact enterprises follow a process to a developed impact framework. Impact enterprises at the start of this process might avoid IMM due to being overwhelmed by the technical jargon. Two transaction managers who invest grants and patient debt in high volumes of impact enterprises suggested that impact-

linking focused on incentivising IMM practices would provide more practical benefit as they experience entrepreneurs putting off IMM adoption until they are fundraising from impact investors. This has the added potential to simplify impact-linking such that high-volume impact investors who cannot develop bilateral investment solutions can engage in impact-linking in some capacity.

Key to building ILF investment-ready enterprises is the provision of TA by intermediaries to ensure quality of impact measurement:

“What we want is the burden to rely on us or the partner and not the entrepreneur. Many times the entrepreneurs don’t have the time or the budget to do impact measurement, so we have to develop the tools for the entrepreneur. Do workshops, do trainings, etc. And also have someone following up their time, their expertise on how to measure those KPIs correctly.” (R6)

Impact enterprises also benefit from working with diverse impact organisations to progress their IMM-readiness:

“No organisation can say their impact evaluation framework is perfect. It’s in a constant state of flux and refinement. ... What we find is each time they work with someone new, they refine their processes, their framework, their understanding.” (R1)

At the other end of the process, a transaction manager finds they can co-create their investment structures with entrepreneurs who understand the enterprise’s growth needs and are willing to engage in a more technical structuring approach. This suggests that ILF is better suited for organisations towards the end of this process.

No respondents referenced meeting financial data requirements as a point of tension in considering ILF, which differs from the conceptual framework presented in section 2.4.

b) Time and costs to obtain impact data

The power of funders is once again evident, this time in incentivising IMM development. Respondents from both ESG and impact investment noted impact measurement requirements pushed down by investors, and donors wanting to see impact achieved.

“For KPI assessment and monitoring, ... you can be spending an enormous amount of time and people and resources on being 100% accurate or you could be 80% accurate; it does the job. It meets your LP’s requirement, and you haven’t gone bankrupt in the process.” (R12)

However, the time and costs to obtain and verify impact data make ILF unsuitable for transaction managers seeking market-rate returns, such as Respondent 12, who are incentivised to minimise transaction costs in the interest of financial return. This element is a major challenge for ILF implementers, which transaction managers have responded to differently.

Although third-party verification of impact performance is understood as best practice, few respondents said they would push for this. Two indicated that they were at times running the measurement or verification on behalf of their investees. In contrast, others were reliant on self-reported data from impact enterprises without verification, due to the cost. When a transaction manager takes up impact verification, it is still at significant cost in terms of time, travel, and other factors, but impressively less so than third-party verification.

“When we start working with the organisations, we see that there are so many gaps in the data that they have, no? That is very, very costly. It’s very difficult to ... gather data and then get information. And so, definitely verification is a challenge. We are trying to do it. I mean, our model relies on that ... we do the verification but we’re trying to move also through a more independent verification way without hiring an independent verifier because I think that’s also one of the – I don’t want to say weakness – but one of the aspects of the impact bonds that will make them difficult to implement because just that component is so expensive, right?” (R14)

Transaction managers with greater capitalisation or funding for verification will still only seek out high-quality measurement services, such as Lean Data impact measurement by 60 Decibels, if there is no option to structure IMM around existing data collection of an impact enterprise or suitable proxies for impact outcomes.

c) Going forward

Over the past twenty years, the bar has been rising globally on what counts as high-quality reporting on impact performance. Together with a fast-growing growing impact measurement industry, these system trends are helping practitioners find a way through the complexity and costs associated with high-quality impact data.

Digital solutions to support IMM and verification hold much hope for transaction managers of decreasing the costs associated with verification and helping impact enterprises to produce high-quality data without overburdening their day-to-day activities.

“I think technology is better and better now to do it. So in terms of forest conservation, so just by hiring, paying a service to verify if there is forest or no forests in certain area should be okay. We're doing that already; we use one platform to do that. But the tools are improving and in the last year or two years maybe, I think there are like six new companies doing this in a much better way.” (R14)

Respondents are particularly seeking such tools for impact data collection from rural communities and farmer customers of agri-businesses. Excitingly, Respondent 17 also referred to IMM innovations that leverage the Internet of Things to track utilisation of products provided by impact enterprises.

4.4.5 Attractiveness

Respondents described limitations to the attractiveness of ILF because ILF investment-ready impact enterprises are scarce, the complexity associated with balancing the various stakeholder interests, the time and costs required for transaction structuring, and legal obstacles.

a) Scarce ILF investment-ready enterprises

Not only is market need in the form of a pipeline of opportunities a determining factor for ILF adoption, but as outcomes contracts tend to be complex, the pipeline of opportunities needs to be sufficient after a considerable level of “pickiness” – respondents cited several barriers to ILF investment-readiness and thus a limited number of companies are perceived to have high ILF potential.

“Our pool of potential companies is already limited to those with significant formal growth potential. Impact-linked finance narrows this pool even further, as it requires companies to not only demonstrate high growth or formal structures but also to have the capacity for impact measurement, particularly for SIINCs. They must also be at a precise point in their growth, typically during fundraising. This criteria creates barriers to the range of companies we can engage with. Despite these challenges, we have successfully identified and transacted with companies that fit the bill, and I

can confidently say that all the companies we've partnered with have been solid choices.” (R11)

The elements of ILF-readiness, not unlike traditional investment-readiness, create a gap between the demand for funding from enterprises and the demand for investment-ready enterprises from transaction managers, however this serves to prevent poor-quality and failing transactions that respondents point out in the current realm of outcomes-based funding experience. Thus, sourcing of pipeline is time-consuming and challenging. Additionally, ILF implementers must consider whether the investment quantum being offered justifies data-related demands on impact enterprises.

While impact enterprises are often experts in impact creation, there is a journey to go on to move into an ILF investment process, which is highly complex relative to a typical grant, equity, or debt investment process. Challenging pre-requisites that an impact enterprise must satisfy are: being on a high-scale path to financial sustainability, ready for a sufficient quantum of investment to justify the due diligence and IMM demands on the enterprise, and impact created should reasonably be attributable to the impact enterprise, making structuring of investments in B2B2C enterprises more complex.

b) Complex balancing of stakeholder interests

Referencing social impact bonds as notoriously time-consuming and complex stakeholder management projects, respondents are cautious of underestimating the stakeholder management burden of coordinating with impact enterprises, outcome payers, other investors, TA providers, external impact verifiers, and any other stakeholders. A respondent advised that ILF is much more suitable for long-term investments in established companies that are not under financial distress, given the time requirement for a multi-stakeholder approach:

“It was time-consuming to set up the partnerships between all of the different providers: the technical advisory, our onboarding process, given it became a bit of this particular impact-linked finance thing... It created a longer delay...” (R2)

The importance of all parties having a well-rounded understanding of the investment structure and their role in it for transaction success creates an imperative for involved stakeholder management and the involved process of structuring ILF incentives together with impact entrepreneurs.

Three respondents highlighted that the risk of market distortion is an important factor, which makes ILF less attractive until further insight into the magnitude of the risk is available. One respondent expressed concern about the longevity of impact beyond the investment period, much like MSDF's personnel when they implemented the first impact-linked debt in section 2.5.9 (Patton Power, 2021). Another concern was that recipients might experience an advantage over competitors doing similar work that cannot be sustained post-investment, as ILF cannot easily be made generally accessible given its extended requirements discussed above, thus distorting market growth. On the other hand, per section 4.4.1, early-stage impact enterprises pursuing growth to commercial sustainability must be able to pivot and take routes that may prioritise financial sustainability over impact in the short or medium term. Particular impact incentives may derail that process and prevent establishment of financially sustainable impact models, contrary to the strategy's objectives.

c) Time and costs to structure transactions

The time and cost of structuring ILF transactions, including specific outcome payer requests such as a grace period, was brought up by most respondents as limiting. All references to outcome contracts were that they are complex and involve a lot of time spent negotiating and aligning on a structure. This complexity deters commercial investment:

“A hallmark of impact investing as an industry is drawing capital available to meet the SDGs and that requires commercial capital, and our experience has been that things [innovative finance and ILF] do get more complex, that it deters that attraction. So there's sometimes trade-offs there as well.” (R13)

From another perspective:

“Many market builders such as the GIIN [Global Impact Investing Network] very much have a key output to grow the volume of capital. ... With that comes a focus on supporting large-scale funds from mainstream institutional capital sources. ... I don't have a problem with that as long as it's not at the expense of the more innovative impact-oriented end of the market.” (R1)

When asked about their current focus in refining their ILF practice:

“Trying to understand how incentives work better. That's definitely something that we are very focused... It's difficult because ... the cases are very diverse and the capacities of each organisation vary a lot, so it's not

easy to set, you know, specific 'this amount of X relates with this incentive', right? It depends very much. It's case by case, really. So that's a bit difficult because it's demanding in terms of time, in terms of follow-up... At the end you have to wait and see if it works or not." (R14)

For ILF implementers adhering to ILF as defined, as opposed to an adapted version (section 2.2.4), the largest amount of time went to structuring the outcome incentives for each enterprise:

"And then the next big sort of hurdle is what is reasonable? What quantum of outcome is reasonable in what duration? And that's where a lot of time is spent. So first, it's in the selection, and then in understanding, and then it's in the identification of what are the metrics you're going to use to measure that outcome and how long will it take and being able to say, okay, this is a reasonable amount of time." (R4)

The transaction costs also need to balance with the quantum of investment, so ILF only makes sense to implement from a certain investment size, which is at odds with impact enterprises' need for early-stage and growth funding.

This limiting factor also relates to the risk of poor-quality ILF transactions as a result of an incentive to cut corners to close transactions at a faster pace. The question of how to address the issue of high transaction costs while prioritising high-quality, sustainable impact is topical across areas of innovative finance. For this reason, mainstream financial institutions and impact investors providing market-rate returns to their investors are not expected to drive innovative finance implementation due to the inherent incentive to minimise transaction costs.

This limiting factor has been a driver of simplified adaptations to ILF incentive structuring. In the case of the ILL fund discussed in section 4.4.4, Respondent 5 relies on impact enterprises to simply guide them on the impact objectives they are pursuing and what an ambitious target to incentivise would be, rather than determining and sizing an incentive using accessible IMM data or market research. The incentive size related to this approach is simplified to a standard proportion of the quantum invested, amounting to a few basis points reduction in investees' interest rate. The added benefit of this approach is the ease of alignment on what is expected of investees, as the impact-linked element is a short and simple addition to their loan agreement.

Another respondent referred to the Aceli Africa model as an interesting response to time-consuming and costly structuring, which leverages standardisation of impact incentives for broader availability to lenders serving agricultural SMEs in remote and informal markets (Aceli

Africa, 2023). Simplified or adapted approaches to impact-linking require proving in the same way as ILF over time, although diversion to alternative impact-linking approaches is effectively limiting when considering adoption of ILF as defined.

d) Legal obstacles

The spectrum, from a transaction manager being beholden to regulatory limitations from how they are registered, to an entrepreneurial approach of finding a way to deploy different types of funding, presents various obstacles that come up in considering ILF adoption. Some outcome payers will not make grants to for-profit transaction managers for regulatory and taxation reasons. Certain jurisdictions tightly control how grants are deployed, while others prohibit certain companies from lending.

“Our greatest problem is how to structure it legally. ... If you’re raising a concrete fund, where you go to LPs, they usually...like you have the certain term sheet; you’re trying to create that return for them, and it doesn’t allow you to do actual blended finance. Yes, you can bring catalytic finance or grants to partner a grant with your investment to be able to further the mission of the entrepreneur, but it’s not packaged in a single product. So I think, as we grow ... we need to think about how to legally structure the company to allow all this type of different financing to come into one single product.” (R6)

ILF instruments exist across the capital spectrum, at times requiring transaction managers to be able to deploy multiple types of funding, or structures that may not have been seen before, depending on the region. There is a risk of investing in a move toward innovative finance that is ultimately inaccessible to certain transaction managers. One solution is to engage partners in an investment structure to legally offer different types of financing.

“We cannot provide granting at all because of the way we’re legally structured. You have to be a 501(c)(3) equivalent, and there’s very strict regulation on how you have to bring the funds, how you have to deploy the funds, the type of impact you’re generating, how you have to report on the impact generated. So that is something we need to be very careful of, and that’s why we partnered with a 501(c)(3) to bring in the grant funding. We do a service agreement with them, ... create the blended finance product, but still complying to legislation.” (R6)

This extra complexity – more significant as transaction managers venture further into innovation – impacts the attractiveness of ILF.

e) Going forward

In general, emphasis was put on the need for simplicity in investment structures, as a pathway to ILF accessibility for transaction managers so that it takes “small effort to offer it” (R5). Often, simple investment structures have proved to be more effective than perhaps more innovative complex structures, and they enable all stakeholders to have a full grasp of the function and objectives of the transaction.

In response to the limiting effect of complex and costly transaction structuring, a few respondents expressed a hope to see increased investment in design fund provision to finance innovative transaction structuring in a pooled approach.

“What I would love to see is there be more market subsidies; more scope to cover the setup, design and other acceleration costs, to help these organisations implement professionally administered solutions and to de-risk these propositions.” (R1)

At least one respondent experiences that public funders, foundations and other philanthropic actors are interested and willing to support structuring of innovative transactions using grants, as they are invested in maximising the impact of their grant investments. However, this funding is specific to blended finance transactions and not widely available for ILF transactions.

Other applications of grant or other philanthropic funding that aid the attractiveness of ILF to transaction managers, is the provision of TA to assist impact enterprises with ILF investment-readiness, including outcomes research funding for impact enterprises on how to identify, manage and achieve their outcome incentives:

“As you know, tracking beyond just outputs requires a deeper level and longer-term analysis that often requires more resources, both financial and human. From what I have seen, early-stage companies do not have an excess of either human or capital resources at their disposal. ... If a hypothesis is that innovative finance isn't adopted more broadly because outcome data isn't there to support the solutions, then at a systems level, I was thinking perhaps a research fund is needed that would provide more evidentiary outcomes to support scaling the adoption of innovative finance... If systems-

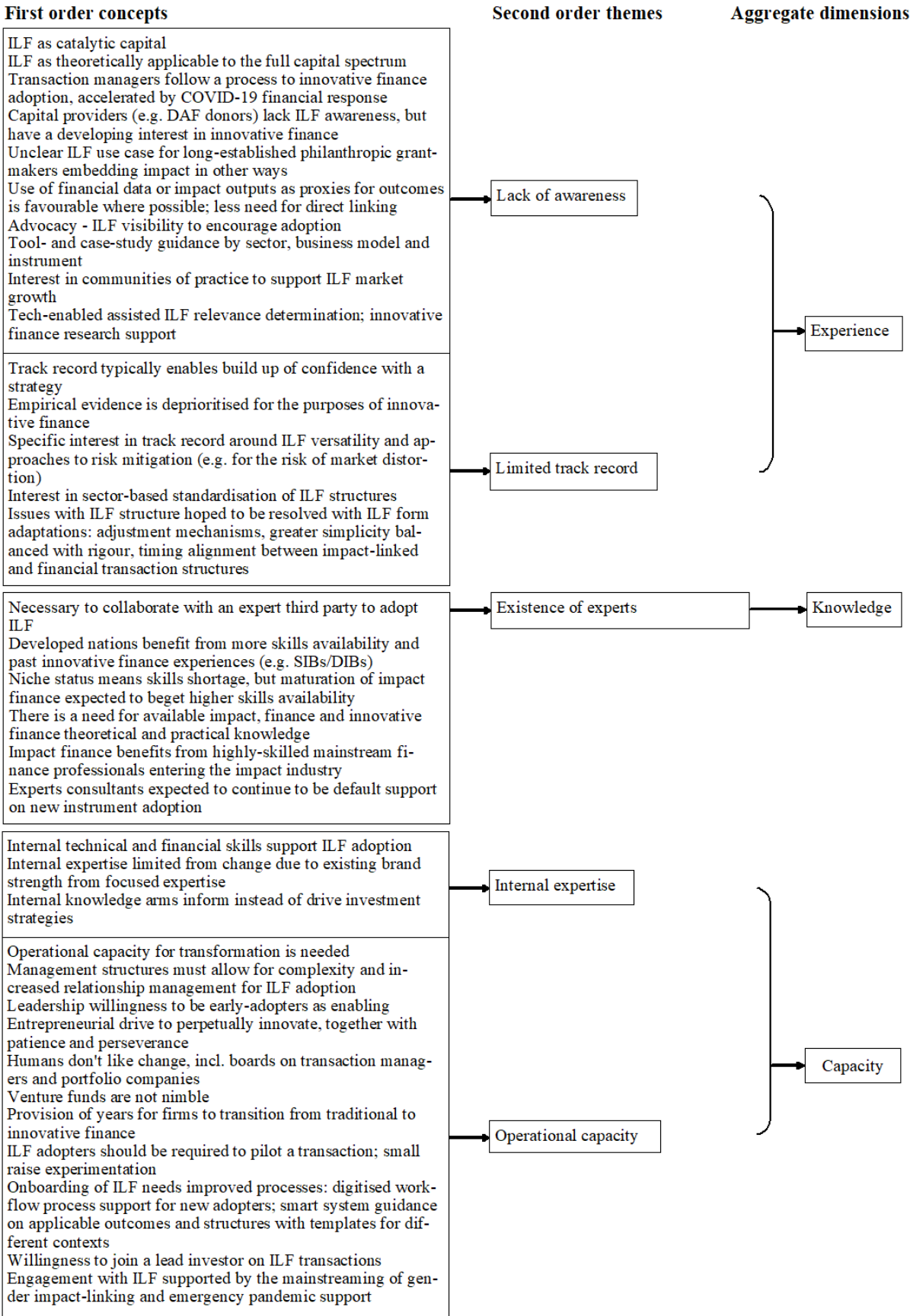
level understanding to unlock innovative finance requires early-stage ventures to report on their outcomes (beyond outputs) then the funding mechanisms have to be put into place to support that without the burden being placed solely on the entrepreneur.” (R20)

Whether such funding should be priced into ILF transactions or provided separately through TA or accelerator programmes is unclear. The former provides a practical route to targeted support for impact enterprises needing to measure outcomes, which are highly-customised to a particular impact enterprise’s objectives, business model, and impact focus, amongst other factors. However, this would prevent support to impact enterprises not associated with a funder. The latter approach, linked with IMM education, provides the benefit of promoting access to impact finance for impact enterprises at a systems level, as Respondent 20 points out.

Lastly, growth in the market of service providers necessary for ILF implementation, such as on-the-ground verification services, or experts to provide TA, will facilitate ILF adoption by reducing transaction costs and difficulty in sourcing and managing stakeholders from transaction to transaction.

The data structure related to factors limiting ILF adoption are presented in Figure 6.

Figure 6: Data structure for limiting factors (Source: Author’s illustration)



First order concepts

Second order themes

Aggregate dimensions

General agreement on importance of IMM and impact verification to validate ILF structure
 Disputable value of more robust impact data
 Self-reporting without verification relying on trustworthiness of entrepreneurs
 Concern of distracting entrepreneurs
 Importance of balancing simplicity and depth in IMM and impact verification; administrative data requirements are unnecessary
 IMM development process for entrepreneurs (i.e. accessibility of technical jargon, refinement with each new industry partner, receipt of TA)
 Incentivisation of IMM (instead of impact outcomes) as an accessible first step
 Bar has been rising on good impact reporting, facilitating innovative finance adoption

Impact data requirement

On-the-ground verification is costly
 IMM often incentivised by funder/donor requirements
 Measurement cost excludes commercial transaction managers from ILF adoption
 Transaction managers operating measurement or verification as a result of costliness
 High-quality impact measurement is insightful if you can afford it
 Tech-enabled IMM and verification to lower costs and liberalise access; must be able to reach end users

Time and costs to obtain

Availability of quality funding opportunities needed to sustain transaction managers in adopting a new investment strategy
 Several barriers exist to an impact enterprise being ILF investment-ready: high growth, formal, fundraising in cases, developed IMM
 Investment sizes need to justify the demands (data-related) on enterprises receiving ILF
 Importance of grants for TA; support for investment-readiness
 Desire for outcomes research funding to support enterprises in achieving metrics

Scarce ILF investment-ready enterprises

Significant stakeholder management burden associated with ILF
 It is necessary for ILF investees to understand the instrument and what it will do for them
 Risk of market distortion - in part unavoidable
 Simplicity is accessibility (in structuring)

Complex balancing of stakeholder interests

Structuring for ILF is time- and cost-intensive
 Outcome contracts tend to be complex; have to deliver on additional investor requirements
 Commercial capital deterred by complexity; ESG supports mainstream funds being mobilised for impact
 Investment size needs to justify the cost of complexity
 ILF implementers should not have the incentive to close transactions at an ever-increasing pace to avoid trade-offs on quality
 Simplified impact incentivisation as an alternative to trade-offs on quality for lower transaction costs
 Desire for design funds to support innovative structuring (ILF and blended finance in general)
 Growth of service provision along the ILF value chain to address various limiting factors

Time and costs to structure transactions

ILF adoption may require the legal capability to make grants or lend
 Different jurisdictions may limit innovative finance implementation
 Potential tax consequences for philanthropies providing grants to for-profit transaction managers for innovation
 First-time ILF adopters are challenged to legally structure investments, but not insurmountable

Legal obstacles

Data

Attractiveness

4.5 Summary

Transaction managers are primarily enabled to adopt ILF through availability of funding; correspondingly, many ILF implementers were enabled to adopt the strategy through their exposure to pioneer outcome payers. Additionally, transaction managers being characterised as innovative finance practitioners, or having a strong commitment to driving sustainable impact are considered enabling factors.

Conversely, ILF adoption is limited where transaction managers lack awareness of the benefits and mechanisms of ILF, or lack the internal capacity to implement the strategy. External limiting factors are the limited ILF track record to date, which is expected to answer several questions as it develops, the lack of ILF expertise to advise on ILF adoption, the tall and costly impact data requirement of the strategy, as well as the time and costs incurred to structure the instruments. The attractiveness of ILF to transaction managers in general is limited by low perceived pipeline opportunities, the complexity around balancing all stakeholder interests, and anticipated legal obstacles with offering such an innovative strategy.

These factors are all within the context of ILF being a relevant strategy for a transaction manager to adopt, based on their investment strategy and target investees.

There were no unanimous responses from respondents; even the most visible factors accumulated a narrow majority of mentions. This may be attributable to ILF's niche status, which is evident even from a group of respondents focused on impact and innovative finance. There was, however, a unanimous expression of positivity and commitment from each respondent to finding the best way to support their chosen group of impact enterprises in fulfilling their impact objectives.

Chapter 5: Conclusion and recommendations

5.1 Introduction

Parts two and three of this chapter summarise and conclude the research findings. Part four summarises the recommendations for different ecosystem actors towards scaling ILF implementation. Part five discusses avenues for future research, which are numerous due to the lack of academic and other research per section 2.5.11.

5.2 Summary of the study

Impact enterprises hold significant potential to push the needle towards achieving the SDGs through commercially viable approaches to sustained impact creation and the ability to innovate with local knowledge. ILF is designed to support impact enterprises to prioritise high-quality impact outcomes while scaling to financially sustain their work. The ILF market is early-stage and building a track record to demonstrate its viability and versatility relative to adjacent impact investing strategies. A future where ILF is available to impact enterprises broadly hinges on engagement of willing and able transaction managers to scale high-quality ILF implementation. The limiting and enabling factors experienced and perceived by transaction managers to influence their decision to adopt ILF was explored; the findings of which are summarised in Figure 7 and discussed below. Italicised factors were identified solely from primary data collection.

This study finds that existing transaction managers evaluate the relevance of ILF for adoption by considering its alignment with their investment strategy and the portfolio companies they aim to support. Necessarily aligned transaction managers make investments (including grants) in the scalable impact enterprises for which ILF is designed, and the number of such transaction managers benefits from more and more catalytic capital providers shifting focus to impact enterprises as vehicles for sustainable impact creation beyond a funder's involvement. Other pre-conditions for considering ILF adoption are flexible fund mandates, trust deeds or other contractual limitations – which venture investors rarely enjoy – and the ability to invest on concessionary financial terms to prioritise impact returns. Thus, catalytic capital providers, such as impact-first investors, venture philanthropists or grantmakers, are best suited to adopt ILF.

In the context of ILF being relevant, the availability of funding is the foremost enabling factor for ILF adoption by transaction managers. While outcome payers benefit most from ILF – alongside impact enterprises – in that they pay only for verified impact outcomes and transaction costs, the concessional finance they make available appears to fall short of demand

Figure 7: Factors influencing ILF adoption by transaction managers

Relevance to transaction managers				
⇒ Investment strategy compatibility				
⇒ Portfolio company alignment				
Enabling factors	Limiting factors			
<i>Transaction manager outlook</i>	Capacity	Data	Experience	
⇒ Innovative finance orientation	⇒ Internal expertise	⇒ Impact data requirement	⇒ Lack of awareness	
⇒ Pursuit of impact goals	⇒ Operational capacity	⇒ Time and costs to obtain impact data	⇒ Limited track record	
INTERNAL FACTORS			NASCENT ILF MARKET	
Funding	Attractiveness			Knowledge
⇒ Access to concessionary funding	⇒ Scarce ILF investment-ready enterprises			⇒ Existence of experts
⇒ Exposure to pioneer outcome payers	⇒ Complex balancing of stakeholder interests			
⇒ Funding sustainability	⇒ Time and costs to structure transactions			
	⇒ Legal obstacles			

Source: Author's illustration

from fundraising transaction managers. DFIs in their capacity as outcome payers could play a bigger role in meeting this demand, however they predominantly seek market-based returns, focusing on later-stage enterprises and a larger investment quantum, with the exception of the DFIs currently taking part in demonstrative ILF programmes.

Currently such pioneering outcome payers have driven ILF adoption by transaction managers through supply of funding and their influence, in so doing promoting market-building and allowing for demonstration of the instruments' viability to in turn attract more outcome payers and transaction managers. Caution should be exercised so as not to drive ILF growth where transaction managers prioritise outcome payers' needs over the impact enterprises or impact industry's shared goals. In fact, transaction managers should be encouraged to guide outcome payers on appropriate strategies, given their closeness to impact enterprises' needs and knowledge of financial instruments that could serve those needs best.

Transaction managers require flexible funding to adopt and develop their ILF practice, in addition to the normal costs of funding, and concessional finance is necessary for transaction managers beholden to commercial investors to implement ILF. Although, such transaction managers may face greater execution risk when tensions between impact and financial returns arise for ILF investees. Transaction managers with their own equity to invest duly enjoy

flexibility and may be drawn to repayable ILF instruments to stretch limited sources of finance to greater impact or avoid the need for continuous fundraising from donors.

Next this study considered the internal factors of transaction managers' outlook on the pursuit of impact and innovative finance, and their internal capacity for ILF adoption. For alignment with ILF, transaction managers should be oriented towards prioritising impact goals relative to financial goals, particularly through innovative finance. To date, most ILF implementers are more generally innovative finance practitioners, with such practitioners responding more enthusiastically to ILF in interviews than those focused on specific impact themes or investing approaches. Arguably, the only imperative for an ILF transaction manager should be their commitment to high-quality, sustainable and scalable impact through their investment practice, which can most directly be affected through impact incentivisation.

In terms of capacity, there are few organisations globally with the capacity and skill to effectively implement high-quality ILF and support IMM development (König, 2022). This capacity comprises operational capacity for transformation and internal expertise, as transaction managers' strategic decision-making is often driven by the expertise they have – what they are good at doing, or what strategy they have built a brand around – making them less likely to pursue a financial instrument with which they are unfamiliar. For ILF adoption, a balance of technical impact and financial skills are necessary, which can present a steep learning curve, but the competencies can certainly be developed, or sourced through suitably skilled consultant workers.

Traditional finance providers, such as grantmakers, may find the practices, cultures and mindsets assumed by ILF particularly difficult adjustments to make. This could be compounded at times by well-established philanthropic organisations being slower in general to respond to updated strategies. If sufficient persistence and enthusiasm for innovative finance does not exist at an individual-level, recoverable grants may be a more accessible instrument with which to shift to investing repayable financial instruments.

Turning to the necessary operational capacity, it is necessary that transaction managers be able to partner impact enterprises through the investment process, rather than directing the process or pushing a level of standardisation, which may cause misalignment between the transaction structure and the enterprises objectives, risking failure of the incentivisation structure. It is labour-intensive to play this role and keep in touch with what is happening on the ground through the investment term, however honest and transparent communication with the various

stakeholders around respective objectives is a lever to support the integrity of any blended finance transaction.

Further, continuous evaluation of ILF successes and failures over the long-term is necessary for appropriately efficient learning and adaptation of the investment model, which adds to the time-cost of ILF adoption. Thus, entrepreneurial leadership who continuously seek to better achieve impact goals with openness to innovation are key to creating long-term sustainable impact through ILF. Leadership deluged with day-to-day responsibilities, particularly in younger funds, may struggle to do deep learning around ILF. The operational and expertise demands of ILF thus filter for transaction managers that lack the capacity to adopt ILF, or rather require that transaction managers have built necessary capacity and buy-in to the relevance of ILF prior to commencing adoption processes.

Limitations to ILF adoption as a result of its early-stage market are summarised by experiential and knowledge factors. Given its complexity and skill demands, it is expected to be necessary to continue contracting expert advisories to aid ILF adoption, which pioneer implementers are working to chart a roadmap through. Still, increased ILF expertise availability is necessary to facilitate adoption.

While practitioners tend to quickly grasp the value proposition of ILF when it is introduced, an awareness of its benefits and mechanisms are not so quickly apparent, particularly in the context of transaction managers' focus geographies and sectors. Seasoned impact-first investors wonder at the value of impact incentivisation where impact is already deeply embedded throughout their investment processes, while others are concerned about impact incentivisation impeding an early-stage impact enterprise's ability to reach commercial viability. Transaction managers look to ILF's track record to provide clarity on the above, although experiences to date are limited.

Additionally, a lack of well-established impact investment language hampers the ease of communicating and comparison within the broader industry to develop ILF awareness. There are a range of investment practices referred to as ILF that may not meet its design principles or even the Baic et al. (2019) definition, however clear delineations and associated language are yet to emerge. It is possible that ILF variations outside ILF as defined will contribute to a broader range of impact incentivisation methodologies as the market matures, but clear and relevant language is a first step to making the market navigable by interested transaction managers.

The next factor limiting adoption of ILF is its attractiveness for transaction managers, with considerations ranging from scarce pipeline, the complexities of balancing multiple stakeholder interests, legal obstacles to ILF adoption and the time and costs of transaction structuring and legal obstacles to ILF adoption. Several barriers to ILF investment-readiness exist for impact enterprises, which strains the investment sourcing process. ILF is designed to produce a win scenario for all stakeholders, with the responsibility to balance stakeholder interests with transaction managers. The success of a transaction relies on this balancing act, with potential failure accompanied by reputational risk. This is particularly daunting given the unanswered questions around ILF's track record. From a legal standpoint, ILF can require transaction managers to be able to deploy multiple types of funding, which is a regulatory challenge, although this has been addressed in the past through partnerships and innovative legal structures.

The time and costs to structure an ILF transaction is perceived as outsized in the market, and is referenced as the largest time drain for ILF implementers. There is a lack of clear guidance on how best to select and structure appropriate incentives, and where structures become complex, commercial investors may be deterred from co-investment or follow-on investment. The complexity of this stage creates a risk that quality is compromised to reduce transaction costs; likely a better alternative (and thus a limiting factor) is implementing a simplified ILF structure as a few respondents had done. A key theme throughout this study is that simplicity promotes accessibility. However it is a challenging trade-off with rigour, particularly as there is limited evidence to substantiate the need for enhanced rigour where simplified impact-linking seems suitable to a transaction manager.

The final limitation of ILF adoption explored is its impact data requirement and the time and costs to obtain that data. ILF utilises impact data for evaluating potential investments, structuring outcome incentives, measuring and reporting on impact, and impact enterprises having a well-developed IMM framework is key to ILF investment-readiness. Transaction managers tend to appreciate the importance of IMM, but less so third-party verification, which is seen as overly rigorous or expensive by some, and by others a key value creator for any outcomes funding. Transaction managers' concerns include that IMM or external verification should not overburden or distract already-busy impact enterprises, as well as the challenge of designing and negotiating outcome incentives that are measurable at an affordable cost, in balance with the financial incentives. The latter challenge requires transaction managers to have

knowledge of the cost of data collection and verification, with the availability of local impact verifiers varying from region to region.

The bar has been rising globally on high-quality IMM and reporting, accompanied by a fast-growing impact measurement industry to help practitioners navigate this complexity. Impact investors with large early-stage grant or loan portfolios see greater benefit in linking their financial terms to impact measurement or reporting, as opposed to impact outcomes; reminiscent of the Impact-Ready Matching Fund. This would be more accessible to a broad range of impact enterprises, so long as TA was available alongside. After all, enterprises' IMM frameworks benefit from each new transaction manager, accelerator, consultant and otherwise that enterprises interact with, and more mature impact enterprises will have seen many.

As clearly defined, measurable, objective impact metrics are required for ILF success, more mature impact enterprises with measurable outcomes, the ability to co-create well-aligned metrics and to shoulder risks, are better suited to receive ILF instruments such as SIINC or ILL.

5.3 Recommendations

For market-builders, in addition to capacity-building across the ILF value chain, transaction managers will benefit from enhanced system coordination to access flexible funding with which to implement ILF. Continued advocacy and visibility of ILF transaction experiences can build excitement and draw in appropriate transaction managers to learn more. Regarding learning resources, respondents look to Roots of Impact for continued provision of educational and case study-based resources, which would ideally evolve as more is learnt about where and how ILF works, informed by on-the-ground experiences. Specific learnings being sought from the growing track record include guidance on context-appropriate outcome incentives, ways to simplify implementation, more insight into adjustment mechanisms for responding to impact enterprises' changing business models and environments, and some degree of standardisation from understanding which instruments and approaches work best and when.

For outcome payers, pooled design fund provision to finance transaction costs associated with pioneering innovative finance transactions would enable transaction manager engagement toward highly-impactful financing structures. Furthermore, the provision of pooled ILF funds focused on particular impact themes is a promising solution to increase targeted funds flow and centralise structuring activities for cost efficiency. It would pay off in long-term dividends to invest in development of the IMM and impact verification markets to build capacity and develop solutions for better impact data at an affordable price.

For transaction managers interested in ILF, explore all opportunities to implement ILF as co-designed by Roots of Impact and the SDC as there are concrete motivations for its design. If there are limiting factors that make this unfeasible, rather than compromising implementation, consider co-investing in an ILF programme, or providing smaller scale incentives, to build your exposure and confidence with impact-linking, as ILF best-practice requires rigour for effectiveness. If you have the internal capacity to begin adopting ILF, start with a pilot transaction with a small raise and draw on any ecosystem partnerships that can assist the process. No two ILF deals look the same and as such, it is necessary to build on experiences to offer a sophisticated product. Work to ensure complete alignment amongst your team on why ILF is being implemented and how to get to a point of readiness to adopt ILF, considering the individual incentives of team members. Then, share your experiences and take advantage of the collaborative nature of the impact finance world to develop ILF in communities of practice and through peer exchange.

For public sector actors, take note of the growing adoption of financial instruments by grantmaking institutions and consider adoption of innovative finance wherever possible to benefit from its impact gearing. Grantmaking and concessional capital availability for transaction managers or other ecosystem actors are powerful means to promote the scale of impact enterprises. Engagement can be independent or in collaboration through demonstrative ILF programmes, which provide exposure to transaction managers on ILF

For impact enterprises, communicate your needs to transaction managers, as they hold enabling influence over outcome payers' decision-making. Focus on developing an IMM framework that enables outcomes measurement as the key to ILF investment-readiness. The world of IMM theory is fast-growing and keeping track of this growth can be useful for more efficient IMM development. Engage with as many ecosystem actors as possible around IMM, as they can assist with refinement and feedback.

Lastly, efforts to encourage ILF adoption in developing countries should be specifically undertaken, as these complex markets will particularly benefit from ILF with the dual-benefit of entrenching ILF adoption in a decentralised manner thus making ILF widely available to impact enterprises worldwide. Likewise, capacity-building amongst local impact verifiers can realise powerful cost efficiencies toward greater ILF feasibility.

Refer to Appendix E for detailed recommendations by ecosystem grouping.

5.4 Conclusion

Achieving relevant scale in ILF implementation capacity is reliant on the adoption of ILF by transaction managers. Where ILF is a relevant solution for a transaction manager to adopt, adoption is enabled by transaction managers having an innovative finance orientation and a prioritisation of impact over financial objectives, as well as concessionary funding availability, likely through exposure to a pioneer outcome payer. Alternatively, the repayable elements of ILF may attract transaction managers looking to utilise their funds more efficiently for impact.

A lack of awareness of ILF has limited adoption to date as it is a niche strategy with a limited track record for informing how and where ILF is best deployed. Similarly, the limited number of experts with the necessary range of skills to support high-quality ILF implementation creates a bottleneck for support to new ILF adopters. ILF becomes less attractive to transaction managers when consideration is given to the high level of requirements for ILF investment-ready enterprises, the complexity of balancing various stakeholder interests at an affordable cost for the transaction to succeed, as well as some consideration of legal obstacles. In addition to the complexity of structuring, transaction managers are prevented from ILF adoption where their target investees cannot meet the impact data requirement of ILF without disproportionately high associated costs. Furthermore, suitable transaction managers can only consider adoption of ILF when they have sufficient operational capacity and internal expertise to start the process.

In conclusion, the factors limiting ILF adoption by transaction managers are significant, while the benefits of ILF largely flow to outcome payers and impact enterprises. Interventions and targeted market-building must be undertaken to address the limitations where possible.

5.5 Avenues for future research

Given the exploratory nature of this study, quantitative analysis of the weight of each identified factors' influence would enable a more targeted utilisation of the insights by ecosystem actors. It would also be beneficial to further contextualise the factors within the full continuum of innovative finance, with the objective of facilitating the evaluation of which instruments are appropriate in different circumstances, and which ecosystem actors are best-positioned for adoption. A good example of this is Patton Power's "Adventure Finance" (2021).

As funding was listed as a major enabler of ILF adoption, research on the factors that influence concessional capital provision to transaction managers would provide useful insight into this central lever of change. The study also noted a growing trend of innovative finance adoption

by long-established grantmakers, and research into this trend and how to support grantmakers transitions can be used to scale implementation capacity amongst both transaction managers and outcome payers.

Further research exploring how the enabling and limiting factors explored may differ across gender may present interesting opportunities to grow the ILF practice. In a similar vein, some respondents pointed to the growing prominence of gender lens outcomes funding as interesting for their adoption as there is a perception that the burden of impact measurement related to gendered impact outcomes is lower. Thus, research into this and other areas of investment with low barriers to measurement may materially facilitate transaction managers' decision-making regarding ILF adoption.

To facilitate ILF's path to scale, research on the growth of established innovative finance strategies, such as impact bonds or venture debt, and what they may have in common with ILF's growth path can guide capacity-builders. Similarly, research on ILF's overlap with RBF, outcomes funding and other strategies may help to clarify the boundaries of these strategies and provide suitable terminology with which to ensure an efficient use of the different instruments.

To ease the burden of complexity for transaction managers, academic research can be done on methodologies to optimise incentive-setting for market distortion or under-incentivisation avoidance (Baic et al., 2019). Regarding impact incentivisation of transaction managers at an individual level, investigation of the flow-through effect of impact-linked compensation to incentivising impact enterprises may offer another lever of change to incentivise high-quality ILF implementation (Patton Power et al., 2024).

There is a lack of information on negative ILF experiences – where ILF has failed to support impact enterprises or create additional impact. A respondent pointed out that practitioners are incentivised to publicise their successes and conceal their failures, thus academic researchers are well-positioned to provide insight into ILF-specific risk factors to support transaction managers in their implementation activities.

Investigation into the system effects and mitigants of impact finance innovation and management predominantly being in developed countries while deployment of funds is largely in developing countries, would aid ILF in scaling sufficiently to push the needle on the SDGs. As respondents pointed out, the complexity and magnitude of development needs in developing countries necessitate innovative finance, and the instruments may need country-specific

adaptations for local transaction managers to benefit from ILF knowledge-sharing and effectively implement the strategy

Voices such as Dr Dambisa Moyo (2009) have highlighted the role of foreign-aid flows in fuelling corruption and fostering dependence on the continent. ILF is a meaningful solution for the misallocation of funds by only structuring payments around verified impact achieved in a rigorous way. Research to understand this in practical terms may make a powerful case for the attractiveness of ILF and rationalise the transaction costs associated with it when those costs are not only compared to traditional financial instruments, but also to the prevention of losses of philanthropic funds to state capture.

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Appendices

Appendix A – Consent Form

Master of Commerce in Development Finance

INTERVIEW CONSENT FORM

Participant name:

I volunteer to participate in a research project conducted by **Janine Rutsch** as partial fulfilment of the requirements for the **Master of Commerce in Development Finance Degree** at the UCT Graduate School of Business. I understand that the research is designed to gather information about **the adoptability of impact-linked finance (“ILF”) for transaction managers** and that I will be one of approximately 20 people being interviewed for this research.

Objectives of the research

1. To explore the factors preventing adoption of ILF by transaction managers and limiting implementation capacity in the broader ILF market; and
2. To understand the factors that draw transaction managers to adopt ILF from their current experiences, as well as their perceptions of factors that would be enabling going forward.

Ethics approval

The ethical clearance for this study was approved by the UCT GSB Research and Ethics Committee on 19 October 2023.

Participation and confidentiality

I understand that my participation in this research is voluntary, that I will not be compensated and that I may withdraw at any time. The interview will be conducted in writing and asynchronously.

I understand that I will not be identified by name in any reports using information obtained from this interview and that my confidentiality as a participant in this study will remain secure. Subsequent uses of records and data will be subject to standard data use policies which protect the anonymity of individuals and institutions.

Should you have any questions or concerns please contact me (rtsjan001@myuct.ac.za or jrutsch@roots-of-impact.org) or my supervisor (latif.alhassan@uct.ac.za).

Consent

I consent to participate in this interview, based on the terms outlined above and subject to the following additional condition of my own (if any).

Signed by interviewee

Date

Signed by student

Date

Appendix B – Interview Guide and Interview Protocol Matrix

Tell me about yourself and your firm:

- Role (Individual)
- Years of experience (Individual)
- The financial instruments implemented (Firm)
- Mission/mandates (Firm)

Tell me where you would place your firm on the spectrum of impact investment, in terms of how you weigh financial vs impact returns?

- Based on your understanding of ILF, please explain where you see it sitting on the impact investment spectrum?

From your established position in the impact investing world, have you noticed any recent changes in capital providers' interest in innovative financing instruments?

- What influence does this have on your firm's investment strategy?
- What new or innovative financial instruments do you find most relevant or attractive? Why?
- What are the key considerations that you and your firm make when evaluating new investment strategies and instruments?

How does your firm integrate impact into its investment strategy?

- Does your firm currently track impact KPIs of investments throughout the investment period? Why/why not? If not, have you explored other means of doing so?
- What has been your experience with the integration/s you mentioned?
- How do you currently address these challenges?
- Are there types of support that would be particularly beneficial for addressing these challenges?

What considerations are keeping you from linking your product terms to impact outcomes?

- What might allow you to change strategy to implement ILF transactions?
- If your firm were interested in adopting ILF, would you prefer to do it in-house or use a third party? Why?

What good enabling tools would allow your organisation to take a bigger step towards ILF?

- What would be important features of the [tool suggested as useful by the interviewee] that you would look for to make it more accessible to your organisation?
- When implementing/If you were to implement ILF, which area of the investment process would you expect to benefit most from additional tools, templates and guidance?
- Is your firm subject to any constraints that we haven't spoken about when considering the adoption of ILF, or use of third-party tools for implementation support? These constraints could be organisational, legal, or otherwise.

What types of organisations does your firm invest in, and do you see ILF as suitable for your investees?

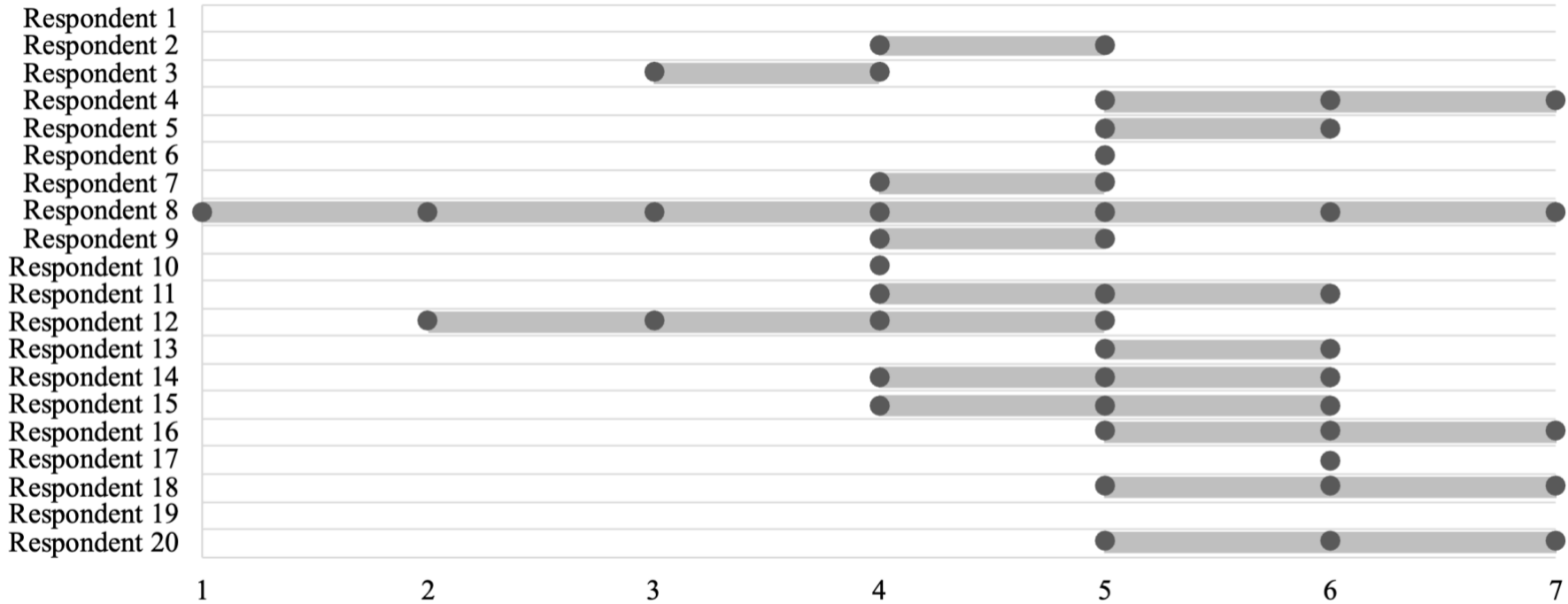
Table 4: Interview protocol matrix

	i. What are the limiting factors experienced and perceived by transaction managers that prevent adoption of ILF where it would be suitably applied?	ii. What are the enabling factors experienced and perceived by transaction managers that increase the use of ILF?
Can you tell me where you would place your firm on the spectrum of impact investment, in terms of how you weight financial vs impact returns?	X	
Based on your understanding of ILF, please explain where you see it sitting on the impact investment spectrum?	X	
From your established position in the impact investing world, have you noticed any recent changes in capital providers' interest in innovative financing instruments?	X	X
What influence does this have on your firm's investment strategy?		X
What new or innovative financial instruments do you find most relevant or attractive? Why?		X
What are the key considerations that you and your firm make when evaluating new investment strategies and instruments?	X	X
How does your firm integrate impact into its investment strategy?		X
Does your firm currently track impact KPIs of investments throughout the investment period? Why/why not? If not, have you explored other means of doing so?	X	X
What has been your experience with the integration/s you mentioned?		X
How do you currently address these challenges?		X
Are there types of support that would be particularly beneficial for addressing these challenges?	X	X
What considerations are keeping you from linking your product terms to impact outcomes?	X	
What might allow you to change strategy to implement ILF transactions?	X	
If your firm were interested in adopting ILF, would you prefer to do it in-house or use a third party? Why?	X	
What would be good enabling tools to allow your organisation to take a bigger step towards ILF?	X	X
What would be important features of the [tool suggested as useful by the interviewee] that you would look for to make it more accessible to your organisation?	X	X
When implementing/If you were to implement ILF, which area of the investment process would you expect to benefit most from additional tools, templates and guidance?	X	X
Is your firm subject to any constraints that we haven't spoken about when considering the adoption of ILF, or use of third-party tools for implementation support? These constraints could be organisational, legal, or otherwise.	X	X
What types of organisations does your firm invest in, and do you see ILF as suitable for your investees?	X	X

Appendix C – Respondent placements on the spectrum of capital

Figure 8: Respondents placement of their organisations on the spectrum of capital

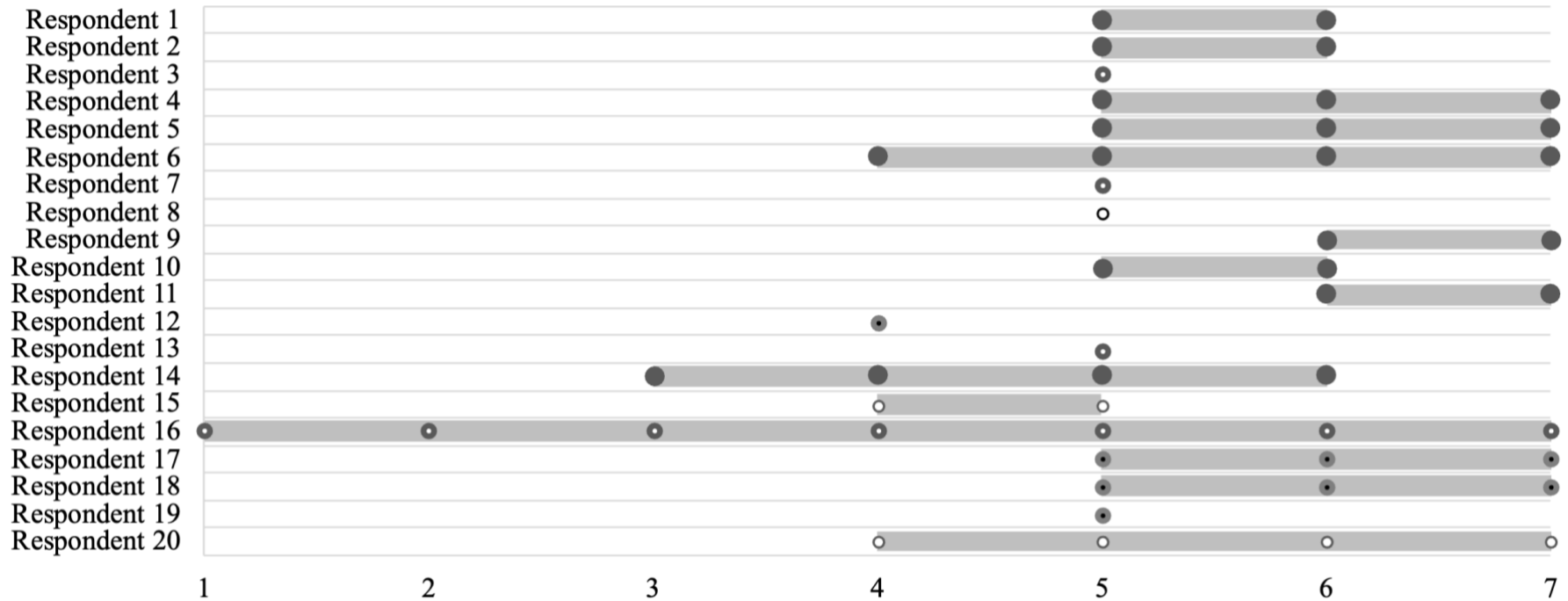
Impact investment spectrum adapted by researcher (Bridges Fund Management, 2017; Leijonhufvud et al., 2019)	Financial-only	ESG investing		Impact investing			Impact-only (Philanthropic grantmaking)
		Responsible investing	Sustainable investing	Thematic investing	Impact-first investing	Venture philanthropy	
	Seek market-rate, risk-adjusted financial returns				No financial returns		
	Mitigate ESG risks						
	Pursue ESG opportunities						
					Contribute to measurable, targeted impact solutions		
					Catalytic capital: Fill capital gaps for impact enterprises and facilitate additional investment		



Appendix D – Respondents’ placement of ILF on the spectrum of capital

Figure 9: Respondents’ placement of ILF on the spectrum of capital

Impact investment spectrum adapted by researcher (Bridges Fund Management, 2017; Leijonhufvud et al., 2019)	Financial-only	ESG investing		Impact investing			Impact-only (Philanthropic grantmaking)
		Responsible investing	Sustainable investing	Thematic investing	Impact-first investing	Venture philanthropy	
	Seek market-rate, risk-adjusted financial returns				No financial returns		
	Mitigate ESG risks						
	Pursue ESG opportunities						
	Contribute to measurable, targeted impact solutions						
	Catalytic capital: Fill capital gaps for impact enterprises and facilitate additional investment						



Key: ● ILF implementer, exposure to ILF in practice, or engaged in simplified impact incentivisation; ◐ familiar with ILF prior to interview; ◑ some prior knowledge of ILF, explanation provided in interview; ○ no prior knowledge of ILF, explanation provided.

Appendix E – Recommendations to stakeholders

Table 5: Recommended actions to promote ILF adoption by transaction managers

Detailed actions derived from research findings	Identified factor	Market-builders & researchers	Outcome payers incl. public sector	Transaction managers	Impact enterprises
<i>Provision of finance</i>					
Make flexible funding available for testing and development of innovative finance strategies, through standalone or collaborative programmes. In particular, concessionary finance is enabling of structuring for the best interests of impact enterprises as key impact value creators.	Funding		X		
Provide concessional funding for TA on investment-readiness to boost pipeline for transaction managers of ILF.	Attractiveness		X		
Subsidisation of ILF investments is needed from pioneers through the nascent market stage to demonstrate viability of the strategy.	Funding		X		
Balance the above action by taking steps to ensure transaction managers are focused on serving the needs of impact enterprises, as opposed to those of outcome payers.	Funding	X	X	X	
Encourage ILF exposure through co-investment opportunities where the lead investor makes structuring decisions that transaction managers find difficult to justify at this stage of ILF market growth, such as to implement third-party verification of outcomes. In this way, transaction managers can increase their confidence around ILF's uses and benefits.	Capacity	X	X	X	
Design and provide pooled fund structures to enhance targeted impact funds flow, including to pooled ILF programmes, such as the ILF for GIF (ILF Fund, 2023b). Sector-based pooling enables the realisation of synergies, access to classes of institutional investors and reduced transaction costs (Baic et al., 2019).	Funding	X	X		
Coordinate the provision of pooled funding earmarked for transaction design to address the bottleneck of high transaction costs and support the structuring of pioneering or highly impactful investments (ILF or other blended finance).	Attractiveness		X		
Transaction managers should harness their understanding of impact enterprises' needs and innovative finance knowledge to guide outcome payers on the most appropriate investment strategies.	Funding			X	X
<i>Education and advocacy</i>					
Within continued ILF theoretical development, construct a framework of the most suitable circumstances for different ILF instruments and approaches, including guidance on context-dependent actions that support transaction success.	Relevance; Experience; Attractiveness	X			
Continue provision of educational and case study-based resources that aligns with the above suggested framework as track record accumulates. Transaction managers are interested in learning from on-the-ground experiences to account	Relevance; Experience;	X			

Detailed actions derived from research findings	Identified factor	Market-builders & researchers	Outcome payers incl. public sector	Transaction managers	Impact enterprises
for the complexity of ILF transactions (e.g. a database of past transactions stratified by impact theme, sector, or business model, with narrative on success factors and risks). Such knowledge would be helpfully presented in a tech-enabled tool format for guiding research on appropriate instruments or quick comparison of opportunities.	Capacity; Attractiveness				
Increase visibility of ILF transactions taking place alongside advocacy work to build excitement and draw in appropriate transaction managers for knowledge-sharing or co-investment opportunities. Particularly, impact-first investors that apply deep impact integrations to their investment process require clarity on the value-add of impact-linking.	Experience	X		X	
<p>Develop and leverage a community of practice around ILF to:</p> <ul style="list-style-type: none"> • Share knowledge and education on ILF through an open knowledge platform (Baic et al., 2019); • Promote ecosystem connectedness; • Provide networking opportunities for fundraising, pipeline sourcing or partnership-building; and • Include the voices of transaction managers in industry development, including policy development. <p>Suggestions for such a community:</p> <ul style="list-style-type: none"> • Host specifically focused roundtables for collaborative thinking on points of interest; • Actively include developing country ecosystem actors towards capacity-building at a local level; • Provide cross-sectoral communication and coordination to overcome opaque industry segmentation; • Avoid over-association of the community with particular ecosystem actors, which can lead to biased representation of work being done and water down the interest of community members. 	Experience	X	X	X	
Intermediaries should continue to play the role of system co-ordinators, particularly to bring different sources of capital and technical know-how together, given the information asymmetry on available financing structures experienced by transaction managers and others.	Experience	X			
<p>Support ecosystem development efforts to build capacity for scale along the ILF value chain, which includes enterprise support (e.g. accelerators or TA providers), impact verification service provision, research and development of relevant tech-enabled solutions, and advocacy amongst outcome payers, amongst others:</p> <ul style="list-style-type: none"> • Provide coverage across the ILF investment process with necessary support services; • Particularly focus on capacity-building of local impact verifiers in developing countries to drive down impact verification costs, develop local expertise and encourage local adoption for ILF for systems-level impact; • Feedback to the impact measurement industry on standards of measurement and reporting that appropriately balance rigour with simplicity; • Explore digital IMM solutions to reduce the cost of high-quality measurement and verification (e.g. by utilising the Internet of Things to track usage), particularly in hardest-to-reach markets; and 	Data; Attractiveness	X	X	X	X

Detailed actions derived from research findings	Identified factor	Market-builders & researchers	Outcome payers incl. public sector	Transaction managers	Impact enterprises
<ul style="list-style-type: none"> Leverage the full impact enterprise support ecosystem to send a consistent message regarding IMM development and deployment as key for impact investment-readiness, because each new partner engagement contributes to IMM refinement. 					
Actively drive the adoption of ILF (through funding and TA availability) by suitable transaction managers in developing countries to maximise the opportunity for systems-level impact.	Funding				
<p>Inquiries to be made of the growing ILF track record:</p> <ul style="list-style-type: none"> Measure the efficacy of ILF in terms of impact and risk-adjusted financial returns, relative to other financial instruments, on an ongoing basis; Share findings on the versatility of ILF instruments to incentivise impact in different contexts and applications (e.g. for incentivising financial institutions versus other impact enterprises); Investigate mitigations for impact risks, in particular those unexpected impact risks that lead to market distortion or hinder impact enterprises from reaching long-term commercial viability; and 	Experience	X		X	
<i>Theoretical development</i>					
<p>Transaction managers are interested to see the development of ILF principles around the following:</p> <ul style="list-style-type: none"> Methods to simplify the most rigorous elements of structuring ILF for more accessible adoption; Well-developed adjustment mechanisms to preserve the efficacy of ILF transactions through the investment period; Insights to inform development and refinement of standardised ILF approaches for common groups. 	Experience	X			
<p>Build academic research concerning:</p> <ul style="list-style-type: none"> The overlap of ILF with adjacent strategies (e.g. results-based finance) to clarify the types of impact-linking observed in the market; Methods to optimise incentive-setting; Development of ILF design principles; and Simple terminology and framing to optimise communication between actors (Buckland et al., 2021). 	Experience	X			
Balance rigour with simplicity in ILF transaction structuring wherever possible, as simplicity is associated with greater transaction success, accessibility of ILF and thus a greater understanding of transaction structures and requirements by all parties.	Attractiveness	X		X	
<p>Consider establishment of an ILF certification, taking learnings from the Fairtrade certification, through which:</p> <ul style="list-style-type: none"> Standards of practice can be enforced; 	Transaction manager	X			

Detailed actions derived from research findings	Identified factor	Market-builders & researchers	Outcome payers incl. public sector	Transaction managers	Impact enterprises
<ul style="list-style-type: none"> Premiums or non-financial resources, such as networks and expertise, for certified good practice can be provided to support transaction manager commercial viability; and <p>Public and private partnerships can be leveraged for visibility over a certification (Baic et al., 2019) to encourage impact incentivisation to improve quality of transactions and alignment for impact additionality, as well as to encourage transaction managers to contribute directly to impact creation.</p>	outlook; Capacity				
ILF should be approached with a continuous testing and learning outlook. Transaction manager leadership are best-positioned for ILF adoption where they exhibit an entrepreneurial drive to continuously seek better ways to support sustainable impact creation with an openness to innovation.	Capacity			X	
Change-makers within traditional philanthropies should continue to drive innovative finance strategies as a means to extend the productivity of investments and place a greater focus on sustainable impact additionality.	Experience		X	X	
Where well-established philanthropies are transitioning to ILF or other innovative finance strategies, long-term persistence and enthusiasm is required at an individual level due to the inherent slowness of well-developed institutions to adapt.	Capacity		X	X	
Support transaction managers towards ILF adoption-readiness: advocacy and guidance to highlight transaction managers' prime positioning to contribute directly to sustainable impact outcomes, alongside support with internal capacity-building towards embedding innovative finance. Capitalise on periods of accelerated innovation, such as the COVID-19 pandemic.	Experience Capacity	X	X	X	
A sustained requirement for third party expert support on ILF adoption is anticipated. Account for this when considering adoption of the strategy, and build capacity amongst ILF experts to liberalise access to this type of support.	Knowledge	X		X	
<p>Improve first-time adoption and new joiner processes for ILF to render more efficient internal system adaptation and learning:</p> <ul style="list-style-type: none"> Development of digital process support or workflow management software for the ILF investment process presents an opportunity to reduce time needed from expert advisors for transaction managers or their team members who are new to the strategy. ILF adoption is recommended to be precipitated by a pilot programme to familiarise transaction managers with the strategy and its suitability for their purposes. For simplicity, this could be funded by a small investment raise, applying relatively simplified ILF structures to facilitate the learning process. Support for adaptation to appropriate internal processes for ILF – although not dissimilar to other impact investment processes – should be in the context of and accompanied by training. High-quality ILF implementation requires sustained internal process development, thus the use for a tool to navigate the ILF investment process is most valuable as a starting point. 	Capacity	X			

Detailed actions derived from research findings	Identified factor	Market-builders & researchers	Outcome payers incl. public sector	Transaction managers	Impact enterprises
<ul style="list-style-type: none"> Support should focus on: The screening phase, which is particularly time-consuming for new joiners; Due diligence, to guide which areas of impact to focus on for translation into measurable outcome metrics with the potential to be scaled; and The structuring phase, particularly around the type and quantum of outcomes best-suited to incentivisation, depending on the context. 					
In developing simplified impact-linking alternatives or practicing ILF in a demonstrative smaller scale context, account for the risk to transaction success posed by measures taken to limit transaction costs or time, or other design factors.	Attractiveness			X	
Where transaction managers are transitioning to ILF from traditional instrument use (as opposed to purpose-building a fund), provide years for the full transition to take effect. It is necessary for transitioning transaction managers to: engage ecosystem actors for partnership-building, deeply understand the relevance of different innovative finance strategies for their purposes, upskill or source necessary impact and/or finance knowledge, pilot, and then continually refine and adapt the strategy.	Experience		X	X	
Navigate legal obstacles around deployment of multiple types of funding through partnerships covering various legal capabilities. Also learn from the legal paths of related financial instruments in the same jurisdiction, as innovative finance strategies are often re-organisations of traditional financial tools.	Attractiveness			X	
<i>Impact measurement and management</i>					
IMM development and deployment by impact enterprises remains a critical element of ILF investment-readiness and should continue to be facilitated through advocacy and enterprise support (e.g. accelerators), alongside continued development of IMM methodologies to lower the barriers to strong IMM at an enterprise level, such as the costs and complexities of data collection and lack of access to means for researching and achieving measurable impact outcomes.	Data	X	X	X	
Continue to develop generally-accepted IMM theory to increase accessibility of cutting-edge IMM practice, as well as encourage transaction managers to contribute directly to impact creation through ILF adoption or other means.	Transaction manager outlook; Data	X			
Develop an approach to impact-linking for IMM development and deployment that can be applied by volume investors (i.e. requiring limited one-to-one involvement by transaction managers) investing in early-stage impact enterprises. TA support could help supplement one-to-one guidance for enterprises and pitch IMM development at an appropriately accessible level.	Data	X			