

# Insight

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## Impact-linked finance: lessons so far and current market practice

### Practical thinking on investing for development

Insight is a series of practical and digestible lessons on the issues of private sector investment and development. They're based on our experiences, knowledge and research and are aimed at investors, businesses, development professionals, and anyone with an interest in private sector development.

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## Foreword

Impact is at the heart of every investment we make at British International Investment (BII). We pride ourselves on being innovative, pushing boundaries, and continually enhancing our approach to maximise the positive difference our capital can make – whether that's boosting access to finance for female entrepreneurs, or increasing the supply of clean, reliable energy. One way we do this is by structuring our investments to drive impact.

Impact-linked finance (ILF) is a tool that, under certain circumstances, can help us achieve our impact objectives. By directly linking financial incentives (such as management compensation or interest rate reductions) to attaining specific impact goals, ILF fosters a strong alignment between our interests and those of our investees. This collaborative approach ensures companies and fund managers are motivated to achieve sustainable and inclusive development impact, while delivering robust financial returns.

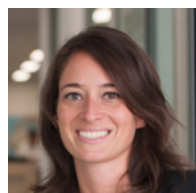
ILF is itself not a new concept. While other organisations have led the way in applying it to debt products alongside concessional or blended finance, we have adopted a more experimental approach, piloting ILF opportunistically across a diverse range of products (debt, funds, and equity) on more commercial terms. Our methods continue to evolve based on emerging lessons from our own experience as well as from our peers.

Yet despite ILF's growing prevalence among impact investors, and a wealth of evidence on outcomes-based incentives more broadly, significant knowledge gaps remain about its application in development finance and impact investing. To address these gaps, we engaged Roots of Impact to examine the contexts, methods and reasons behind ILF's use in the market and to conduct an initial evaluation of our ILF transactions.

I wish to thank the ILF specialists at Roots of Impact for their work, and our partners at development finance institutions (DFIs), impact investors and other practitioner organisations that participated in this study for their valuable contributions. Although the recency of our ILF investments precluded a full impact evaluation, I am encouraged that our ILF transactions generally met Roots of Impact's suitability criteria for ILF and were designed in line with their Design Principles for effective ILF. The study highlights several areas where our approach to ILF is strong, and we are innovating. Our [investment strategy](#), rooted in impact creation, ensures our ILF transactions have the potential to create significant impact. We strive to add value to our investees by aligning ILF incentives with their own strategies for environmental and social impact, as well as through our technical assistance. The study underscores how our model of involving dedicated impact professionals in every transaction adds value when structuring ILF.

The study also provides valuable lessons for us. While the ILF structures we have developed to date show promise, there is room for improvement in setting more ambitious targets, developing clearer guidance, and generating more robust evidence of ILF's impact. We are already addressing these recommendations, with clear practical guidelines for investment and for impact professionals, drawing on the design principles in this report, as well as our recent experiences in delivering ILF.

Looking ahead, our challenge is to scale-up the use of ILF with streamlined, yet cost-effective strategies in key areas of our portfolio. This includes our priorities around gender finance, as highlighted in our recent report sharing [lessons learned from six years of investing in women](#). We also welcome discussions with our DFI peers on generating more evidence-based insights for applying ILF in our portfolio. We hope the insights from this report will help our peers and other impact investors use ILF more effectively.



**Maria Smith**  
**Chief Impact Officer**  
**British International Investment**

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# 1

## Introduction

### Objectives

BII, the UK's development finance institution (DFI), applies impact-linked finance (ILF) to a small but growing number of its investment transactions. ILF refers to investment strategies and financial structures that explicitly tie financial rewards to the achievement of defined social and/or environmental impact objectives. By selectively incorporating these types of incentives into our investment toolkit, we can help align investor interests with those of investees, helping company and fund management teams to fulfil their mandate to amplify social and environmental impact while maintaining adequate financial returns.

Despite the growing use of ILF by impact investors, there is still a significant knowledge gap on its application in the development finance and impact investing space. There are also knowledge gaps on the impact of ILF, its benefits, and potential downsides. To address this, we commissioned ILF specialists Roots of Impact to study how ILF is used in the market and to conduct an early assessment of the effectiveness of our ILF transactions. The research focused on two key questions:

1. Where, how, and why has ILF been employed by DFIs and impact investors?
2. What lessons can be learned from an early assessment of BII's ILF investments?

Since most of our ILF transactions have only been executed in the last two years, it is too soon to measure whether their intended impacts have been achieved. Therefore, the evaluation focused on their suitability and design based on Roots of Impact's Design Principles for Impact-Linked Finance (described in the following section).

The findings offer practical insights and guidance for deal teams and decision-makers into effective ILF structuring, by highlighting ILF practices and early learnings from both the market and our own ILF investments. The insights can also benefit the broader ILF ecosystem, including other DFIs, impact investors, and current and aspiring ILF practitioners.

## Methodology

The study examined ILF applications in direct debt, equity, and fund investments. It combined insights from interviews with 11 ILF practitioners,<sup>1</sup> and a review of 10 of our ILF transactions, using relevant investment documents and interviews with our deal teams and senior management. For the assessment, Roots of Impact developed an assessment tool based on their Design Principles and initial ILF suitability criteria. The assessment tool serves a dual purpose: it can evaluate whether an existing transaction meets the prerequisites for a well-designed ILF structure, or can be used as a checklist to design new ILF transactions.

The assessment relied mainly on our internal resources (interviews with deal managers and development impact leads, and document reviews). Including the perspective of investees would have offered a more comprehensive assessment, such as revealing how well the goals of the impact incentives align with investees' own impact strategies, but this was beyond the scope of our initial research. We therefore recommend interpreting the results with caution.

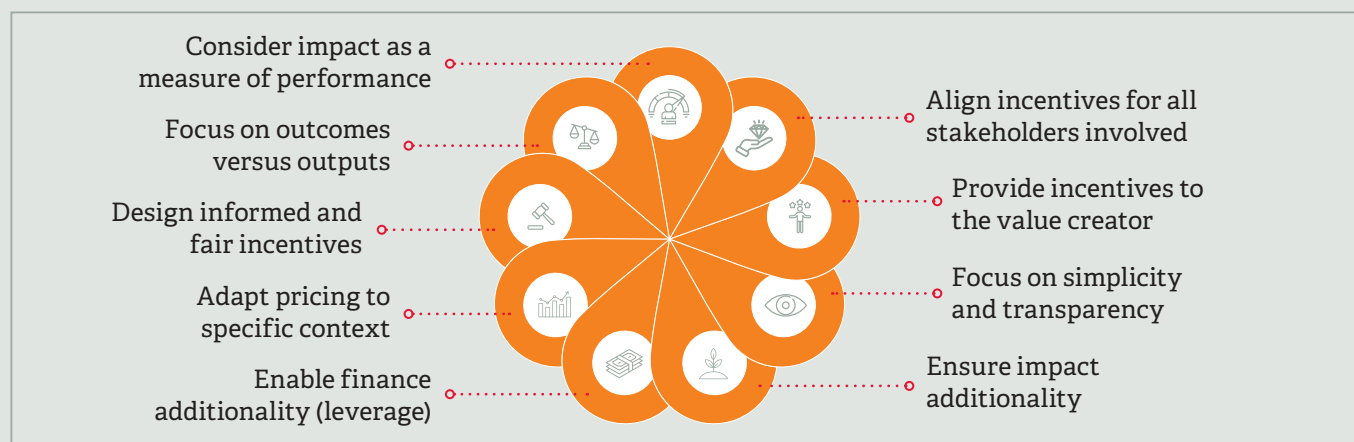
## Structure of this report

The first section of this report introduces the concept of ILF. The second section summarises lessons on ILF practices from other practitioners, which illustrate some of the Design Principles. The final section presents the assessment findings on the quality and effectiveness of the design of nearly half (10) of our ILF transactions. It also offers recommendations for strengthening ILF practice and evidence in future.

<sup>1</sup> This included Aceli Africa, BlueMark, Boehringer Ingelheim, IDB Invest, UBS Optimus Foundation, and Varthana, along with other organisations.

## The ILF Design Principles

The **Design Principles for Impact-Linked Finance** were introduced in 2019 by Roots of Impact, the Boston Consulting Group (BCG), and BCG Henderson Institute in their report **Accelerating Impact-Linked Finance**. The Design Principles aim to enhance the effectiveness of ILF and guide practitioners. They have been updated as experiences with ILF have evolved. In future, the principles will be further developed by a market-neutral body.



There are nine Design Principles. However, not all principles can (or should) be uniformly applied in each transaction. Instead, they should be considered and balanced comprehensively, ensuring a 'fit for purpose' ILF approach optimised for impact.

## The ILF Early Assessment Tool

The ILF Early Assessment Tool draws on the Design Principles across 13 categories, each with formulated questions and a simple rating system (high, medium, and low alignment). Along with the Design Principles, the first four categories of the Assessment Tool focus on the suitability of a transaction for ILF.

### ILF Suitability Criteria

- 1. Impact measurement in place:** Is there a system in place to collect relevant impact data (IMM system)?
- 2. Availability of baseline data:** Are historical data (and projections) available for relevant metrics?
- 3. Feasible timeframe for impact creation:** Is the timeframe of the transaction feasible for creating the intended impact?
- 4. Evidence supporting the impact thesis:** Is there evidence supporting the impact thesis relevant to the transaction?

### ILF Design Principles Criteria

#### Choosing metrics and targets

- 5. Level of metrics (outcomes vs. output):** Are the selected metrics at the output or outcome level? If at the output level, do the selected metrics have the potential to indicate improvements at the outcome level?
- 6. Link between incentives and impact performance:** Are the incentives designed in a way that each unit of impact counts?

#### Incentive alignment, structures and governance

- 7. Incentive alignment:** Are the incentivised outcomes of the ILF transaction aligned with the strategies of all stakeholders involved?

- 8. Incentives to value creator:** Are incentives directed to the stakeholder who is most central in the value creation process and/or has most decision-making power in where/what impact is being created?
- 9. Simplicity and transparency:** Is the incentive scheme and underlying governance simple and transparent enough so that it allows the enterprise to easily understand and calculate their rewards for achieving the targets?

#### Pricing

- 10. Objective and context-specific pricing:** Are the incentive levels or amounts of rewards based on objective criteria (e.g. calculations) and was the specific context considered for determining the pricing?
- 11. Fair and data-driven incentives:** Do incentives effectively attract interest from potential investees while simultaneously providing the best value for the funder through an optimal relationship with the set targets (principle of minimum concessionality)?
- Impact additionality and financial additionality**
- 12. Impact additionality:** Does the ILF structure enable and encourage additional impact that wouldn't have been created otherwise, faster, or better?
- 13. Financial additionality:** Does the ILF structure enable the enterprise to raise investment at the same time or at a later stage and/or is the capital provided to the enterprise additional in itself?



## 2

### An introduction to ILF

#### What is ILF?

**ILF refers to investment strategies and financial structures that explicitly tie financial reward to the achievement of defined social and/or environmental impact objectives.**

The financial rewards from ILF range from direct incentive payments to favourable financing terms, like reduced interest rates or modified repayment obligations. Critically, rewards are linked to pre-defined and verified metrics. Depending on the size and type of the reward, this can create strong incentives to improve impact performance. In an ideal scenario, ILF emphasises rewarding outcomes rather than outputs,<sup>2</sup> such as improved health or the creation of additional income or jobs for target populations. Measurement and evidence of outcome achievement determines the financial rewards provided. ILF holds promise in providing objective and transparent criteria for assessing impact performance, but ILF metrics must be carefully designed to avoid either rewarding superficial achievements that do not align with broader impact goals or rewarding some impact goals at the expense of others.<sup>3</sup> As discussed later, current practices vary.

ILF can be applied across any impact topic or sector, anywhere in the world. Cross-cutting issues such as gender and climate are often addressed in ILF structures, even when the enterprise being incentivised is focused on another area of impact. For instance, a gender target may be established concerning outreach to patients within the health sector.

<sup>2</sup> Outputs are the tangible products or services directly produced by an organisation's activities. These are typically quantifiable and immediate results of the organisation's efforts. Outcomes are the intended short-term and long-term results required to achieve the impact goal. They encompass changes, benefits, learnings, or other effects that result from the organisation's activities. For example, in gender SME finance, an output could relate to funds or loans disbursed to women-led businesses by an intermediary receiving ILF, while an outcome could relate to the growth of women-led businesses supported by the intermediary.

<sup>3</sup> There is strong evidence from similar performance-based incentives showing the importance of avoiding perverse incentives or unintended consequences. See, for example: [Incentives in Organisations, Gibbons, \(1998\)](#) and [Mission and the Bottom Line: Performance Incentives in a Multi-Goal Organization, Giné, et al., \(2018\)](#)



**ILF is not a single product or financial instrument, but a versatile structuring approach that can be deployed across the entire financing spectrum.** ILF has evolved from performance-based cash incentives to include various financial instruments, encompassing debt, equity, and other financial innovations. Figure 1 lists some of the ILF mechanisms in play across the market.

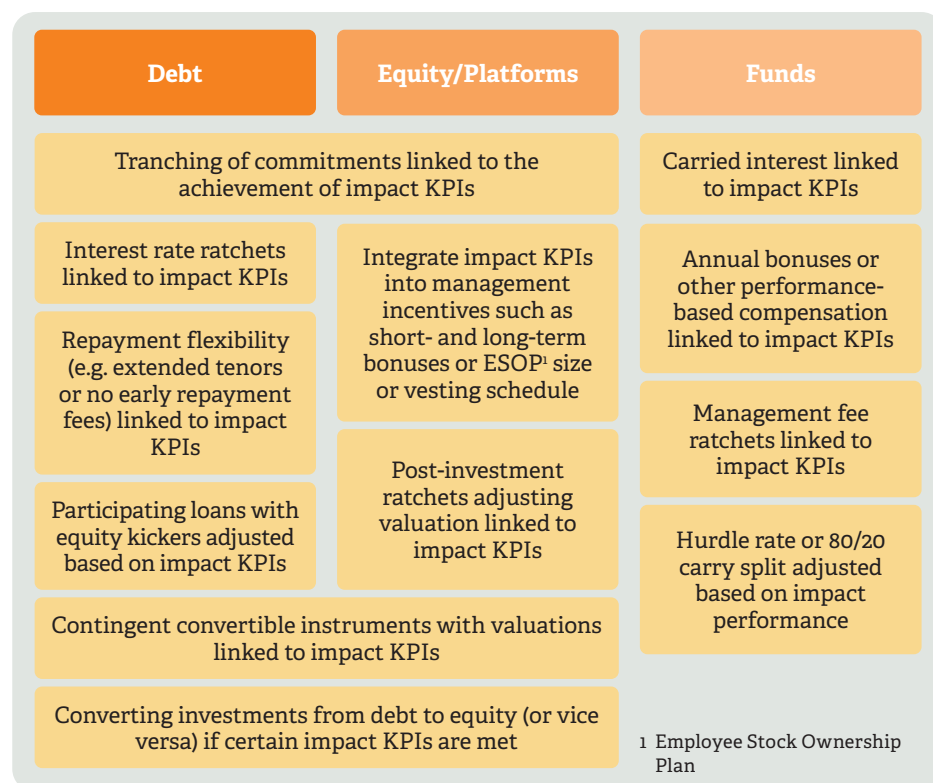


Figure 1: Types of ILF mechanisms

Most practitioners consulted for this study primarily apply ILF through debt products where capital cost reductions hinge on achieving impact targets. BII is one of few organisations applying ILF across the entire spectrum of products, including debt (impact-linked loans), funds (impact carry), and equity (mainly in the form of impact-linked management incentives).

## Key ILF mechanisms discussed in this report include:

### Cost of capital reduction

**Impact-linked loan:** Like a traditional loan, interest rates (potentially even repayment obligations) are tied to the borrowers' achievement of pre-defined social and/or environmental outcomes. The enterprise receives 'better terms for better impact.' The higher the impact achieved by the enterprise, the lower the interest rate to be paid. In some cases, if expected impact is not achieved, the interest rate may increase.

### Management incentives

**Long-term Incentive Plan (LTIP):** Typically used in equity investments, impact-linked LTIP is a compensation mechanism where the long-term incentives for management are linked to the achievement of specific impact targets.

**Impact carry:** A portion of the carried interest for fund managers is linked to impact performance. This means the financial rewards for fund managers are at least partly tied to the impact outcomes of the investments they manage.

**A full list of ILF mechanisms discussed during the research are defined in the Glossary in the Annex.**

**Across the impact investment sector, ILF interest is increasing, particularly using impact-linked loans.**

There is increasing interest in ILF, with new funds and facilities integrating impact incentives into their investment strategies. The ILF market is still at an experimental stage and includes diverse practices and approaches. Practitioners' decisions on ILF implementation are guided by factors such as baseline data availability, ease of target measurement, alignment with mandates or strategies, funding allocation, and information costs. While some adopt structured frameworks, others explore ILF opportunistically across sectors and financial instruments, prioritising flexibility, simplicity, and the use of a few measurable metrics tailored to client needs, recipient profiles, and associated risks.

Given the challenges with developing bespoke structures for each transaction, there has been a noticeable trend towards impact-linked loans with modest incentives, due to their ease of implementation and relatively low cost. Equity investments present additional complexities, especially where practitioners have minority roles in funds or direct investments with limited influence.

**Why do practitioners use ILF?**

Despite ILF being a relatively new approach, practitioners have applied it to a range of scenarios. It was first used with impact enterprises and was later expanded to a broader spectrum of market-based organisations, including traditional enterprises with potential for enhanced social or environmental impact. By offering incentives for achieving impact, ILF helps to align investors and investees on impact intentionality and performance, by incentivising priority impact areas, increasing the impact the investment would have otherwise had, and/or improving impact measurement practices. ILF can also be used to generate demonstration effects or attract new investors.

Our research found that how organisations use ILF depends on their institutional mandates and the capital they employ (in particular, the extent to which concessional capital or blended finance is used). For example, we use ILF predominantly to strengthen the alignment between us and our investees around impact intentionality and performance, and to bring increased attention and rigour to impact measurement and management.





### 3

## Mapping the evolving ILF landscape: insights from practitioners

This section features experiences and insights from practitioners at different steps of the ILF design and implementation process, based on interviews with practitioner organisations. Each organisation brought hands-on experience of implementing ILF in their investment portfolios. The findings are a snapshot of how practitioners are currently implementing ILF in an evolving landscape.

The first set of findings focus on market practices and lessons relevant to the ILF Suitability Criteria and Design Principles on creating additional impact, choosing metrics and targets, governance, and pricing approaches. The second set deliver insights on key enablers for ILF, including verification and technical assistance.

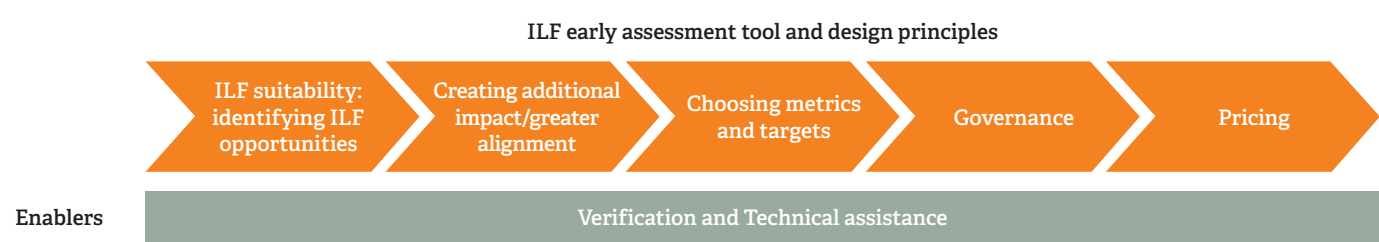


Figure 2: Assessment framework across the ILF process

## **ILF suitability: identifying ILF opportunities**

### **Understanding investee priorities and strategy is important for identifying the 'right' ILF opportunities**

According to Roots of Impact's ILF Suitability Criteria, prerequisites for ILF suitability include having an impact measurement system in place, baseline data, a sufficient timeframe for generating impact, and clear evidence supporting the impact thesis for the transaction. However, there is limited evidence on where ILF works best, in which contexts. In practice, approaches to identifying suitable transactions for ILF vary. There was a consensus among practitioners that deciding whether to use ILF required a nuanced understanding of investee priorities and strategy. ILF practitioners tended to focus on early market movers that aimed to bring new solutions to a market, with the goal of phasing out ILF once the market was commercially sustainable.

Other organisations consulted for this study identify opportunities for using ILF through their blended finance portfolios, using concessional capital (primarily through loans with either interest rate reductions or cash incentives). We stand out for using ILF within our Growth capital portfolio, or for investments with a lower risk profile, without the use of concessional finance.

However, there was a consensus among practitioners that using ILF with investees with established impact or sustainability strategies (including predefined impact metrics) was easier, as it helped to streamline initial discussions and reduce complexity. Investees with established impact strategies often suggest metrics they are already tracking. The availability of data necessary for creating and using benchmarks for setting targets is another important consideration for ILF transactions. For investees without impact strategies or metrics in place, extra effort through technical assistance is often required (discussed later in this section).

Finally, investee management commitment was reported as crucial for ILF suitability. Investees demonstrate commitment to ILF through a willingness to agree to ambitious targets or to incorporate relevant metrics into their management incentive schemes. Senior management commitment makes impact-linked management compensation schemes in equity investments (as used by BII) a potentially powerful lever for ILF. While more evidence is needed to determine the contexts and extent to which these schemes are successful, Roots of Impact's assessment indicated that these schemes are well-aligned to their Design Principles and therefore have significant impact potential.

## **Creating additional impact/greater alignment**

### **There are emerging practices for ensuring ILF brings added value, but more evidence is needed**

ILF incentives and rewards can be used to target outcomes that create additional impact or strengthen alignment (shared commitment) around impact objectives. Creating additional impact and strengthening alignment around impact objectives are two sides of the same coin: while additional impact is about creating more, faster, or better impact in the short- to medium-term, strengthening alignment ensures a predefined type, scale, and depth of impact is continuously achieved and maintained in the long-term. Both scenarios need investors to assess whether ILF will lead to an impact that wouldn't happen otherwise, or whether it achieves the impact more quickly, at a greater scale, or with greater certainty, than the same investment without ILF.

While ILF promises to substantially improve business contributions to strategic impact goals, it is unlikely to catalyse transformational change in a commercially sustainable way if goals are not aligned with investees' existing ambitions. There is limited evidence on the success of using ILF to encourage investees to make substantial capital expenditures or wholesale changes to business strategy without an existing appetite for it (for example, pivoting a company's business plan to serve a completely new market, or motivating a company in a highly-emitting industry to dramatically reduce their emissions). To maximise the chances that ILF successfully promotes change in a commercially sustainable way (that does not require ongoing subsidy), it is important to ensure impact goals are aligned with existing business strategies.

Practitioners expressed a strong interest in understanding to what extent and how ILF creates additional impact. However, they noted a lack of historical business and impact data or industry benchmarks makes constructing a credible base case (what would have happened without the incentive) or scenario projections (with and without ILF) difficult. The costs of rigorous experiments such as randomised control trials (RCTs) may not align proportionally with the insights gained.

Some ILF practitioners have explored different approaches to defining appropriate incentives aimed at creating additional impact and better understanding what works. These include conducting a qualitative assessment of investment opportunities, using feedback loops through negotiating incentive levels with investees (where an unattractive incentive signals the starting point of additionality), comparing results from auction-based mechanisms with expected impacts (e.g., greenhouse gas emission reductions) relative to incentive amounts, and using an adaptive target-setting approach to ensure targets remain sufficiently ambitious for achieving additional impact. At the portfolio level, some practitioners are also conducting ex-post evaluations to compare portfolios with and without incentives (discussed in the next section). Clearly defining the use case and the counterfactual logic for each ILF investment in a theory of change or impact thesis is an important first step for ensuring additionality, even if it cannot be rigorously evaluated.

## Choosing metrics and targets

### Aligning metrics with investee business strategies and balancing materiality and simplicity are crucial

Choice of metrics is an important aspect of structuring ILF transactions, as metrics play a crucial role in steering how investees are expected to generate impact. ILF metrics and targets shouldn't be based on peripheral or 'nice to have' activities, as this risks the impacts incentivised becoming lower priority or a 'tick box' rather than core to the business' operations. ILF practitioners agreed that, as with setting achievable and additional impact goals, aligning metrics with the investee's overall business strategy is vital. To ensure this, investees typically actively participate in metric selection. In some cases, investees suggest the metrics, effectively minimising the additional reporting burden. However, practitioners also emphasised that input from investors is important to ensure metrics align with their impact strategy.

As discussed previously, according to the Design Principles for ILF, metrics should be as closely linked to outcomes and intended impacts as possible – and not just easy-to-measure outputs. Outcome-based metrics could therefore impose significant data collection costs for the investee, which to some extent might offset the incentive provided. For many practitioners, this is linked to the importance of technical assistance (discussed later) to support investees to manage and track their impacts. Some practitioners felt that using standard indicators at the portfolio level is useful for comparing investments. However, this can be challenging for many practitioners due to varying investment contexts and the value of aligning metrics with investee strategies and needs.

There was a practitioner consensus that metrics should be straightforward to measure and verify. While there may be a trade-off between the measurability and materiality of metrics (or their significance to 'outcomes'), it was felt that simplicity and clarity should not be compromised. Practitioners emphasised the importance of carefully selecting a few metrics to ensure a concentrated and effective approach, rather than risk being overwhelmed by an excessive number of indicators.

### **Target setting is sometimes more art than science, but flexibility and co-creation are key**

Setting meaningful targets linked to incentives was considered more an art than a science. Practitioners agreed the challenge stems from a lack of historical data to benchmark and set ambitious, yet achievable goals as well as the dynamic nature of the market environment. Insufficient data and evidence often make relying on quantitative assessments or modelling impractical.

To navigate uncertainties, ILF practitioners stressed the importance of flexibility in target setting. This lets targets adapt to external factors and integrate valuable learnings, especially in the initial years of a transaction. For example, in some instances, investees and investors do not define targets right away, agreeing to establish them after a set period. Another way practitioners set targets flexibly is by adapting timelines. For example, if a target isn't met in year one, achieving it in year two could still secure incentives. In general, flexibility was viewed favourably by investees, which is echoed by other research: 60 per cent of investees consulted in IDB Invest's report on gender-focused performance based incentives<sup>4</sup> highlighted the importance of flexibility, particularly amid challenges like the COVID-19 pandemic.

While targets may originate from either the investee or the investor, ILF practitioners agreed the decisive factor in determining effective targets lies in a co-creation process that enables comprehensive review and constructive challenge by all stakeholders. In addition to leveraging peer insights and historical data whenever available, involving thematic and/or country-specific experts has helped practitioners to further contextualise risks and set ambitious targets.

## **Governance**

### **Governance structures are important for ensuring effective management and strategic alignment throughout the lifetime of an ILF transaction**

A well-designed governance structure is essential for effective management and strategic alignment in ILF transactions. Practitioners reported that the complexity of ILF transactions (especially those with multiple stakeholders) requires clear governance to distribute responsibilities and streamline decision making. This clarity is particularly valuable for transactions with adaptable metrics and targets which require multiple reviews and decisions during implementation. Advisory committees can provide recommendations to ensure ILF metrics are relevant and appropriate. Expertise in the impact area and independence from the transaction are crucial for these committees to be effective and mitigate potential conflicts of interest.

Governance mechanisms can help investors and investees determine how to best-optimize capital for both impact and profit, aiding alignment between sometimes conflicting objectives. Governance structures are also key to ensuring credible impact data measurement and verification (discussed later in this section).

<sup>4</sup> See [Promoting Gender Equality through Performance-based Financial Incentives An Analysis of IDB Invest's Experience](#) (IDB Invest, 2023)



## Pricing

### **Pricing varies widely and is often based on several factors, including the effort required by investees to achieve impact targets**

Incentive pricing should follow the well-established principle of minimum concessionality, where an incentive is not distorting the market, but is sufficiently attractive to encourage and enable action.<sup>5</sup> The process for determining incentive levels should rely on objective criteria and consider the specific transaction context.

Practitioners reported that pricing incentives appropriately involves considering several factors. For investors, the type of capital provided and expected returns play a crucial role. On the investee side, a key consideration is the additional effort needed to meet impact targets. Pricing incentives using data-driven approaches based on results from market analyses of a representative sample of lenders has been done, but was rare among practitioners in our sample.

In practice, incentive levels vary considerably. For impact-linked loans or performance-based incentives (PBIs), examples in the market ranged from 20 to 2,000 basis points (bps)<sup>6</sup> per annum.<sup>7</sup> Practitioners in this study with access to catalytic capital, blended or concessional finance offered relatively high levels of incentives in return for additional impact. While higher incentive levels should intuitively enable and stimulate greater impact, there is a lack of evidence on the extent to which impacts vary across ILF investments priced at different levels (often because neither baseline data, impact projections, nor results are available).

## Verification

### **Verification of investee data is a balance between managing costs and minimising risks**

It is important to consider data availability, data quality, and data collection procedures as part of how impact metrics are selected, measured, and verified. Practitioners reported needing to balance practicality and costs with making sure the impact measurement is done to a high standard.

Verification practices for ILF metrics vary, from no verification at all to independent third-party verification. Specific transaction characteristics – such as the type of investee, the incentive structure, and investor standards – influenced these practices. Generally, the evaluators found that external verification mechanisms lacked rigour across many ILF arrangements, particularly in smaller deals where reliance on self-reported data from investees was common. However, audits conducted by external verifiers or the ILF provider itself are sometimes contractually agreed as an option which can be used when necessary.

Practitioners agreed that finding the right balance between managing costs and avoiding risks is crucial in determining the appropriate level of verification. Practitioners relied more on the integrity of investee-reported data in ILF transactions involving regulated financial institutions (FIs), which reduced the need for external verification. Similarly, robust internal reporting processes within investee organisations (subject to regular review and audit) made practitioners more confident in the accuracy of self-reported data. Practitioners noted that concerns typically arise when the costs associated with external verification are out of proportion with the incentives provided, particularly when these costs are borne by investees.

<sup>5</sup> See [What is minimum concessionality?](#) (Convergence, 2019)

<sup>6</sup> Basis points are used to describe changes in interest rates, management fees, and other rates in finance. One basis point is equivalent to 0.01 per cent.

<sup>7</sup> 2,000bps were used by one investor in the context of offering loans to micro and small enterprises, but in general, incentive levels were lower, ranging from 20bps to 100bps for some organisations to 200bps to 700bps for organisations providing very small loans.

## Technical assistance

### Technical assistance is often a crucial part of building investees' capacity for ILF

Many impact investment fund managers and DFIs incorporate technical assistance (TA) programmes into their financial offerings. TA is not used to directly assist businesses to meet ILF targets; the investee should be able to meet impact targets through its core business. Rather, TA acts as an enabler through improving skills, knowledge, and capabilities related to designing and verifying ILF. Evidence shows TA can improve investee competitiveness, enhance business performance, amplify impact, and strengthen markets and sectors.<sup>8</sup> Not surprisingly, interviews with ILF practitioners revealed that TA is often bundled with ILF. While the impact of TA on optimising ILF effects remains unclear, initial evaluations show promising results: IDB Invest's assessment of their gender-related PBIs found that "the implementation of TA alongside the application of incentives built necessary capacity across clients and aligned interests across stakeholders."

In practice, TA is customised to meet investees' specific needs, but generally falls into the following categories:

- **Designing ILF:** Building an impact measurement and management (IMM) system – TA is often necessary to support investees to collect and manage data under the incentive scheme, including activities like establishing databases and improving capabilities for data disaggregation. Combining policy implementation with robust data systems is important for ensuring long-term results. At BII, we also use TA or specialist consultant support to help design ILF structures' measurement frameworks at the outset.
- **Implementing ILF:** Setting up policies or impact strategies – TA at the strategic level can involve sharing or advising investees on policies and frameworks (such as environmental, social and governance (ESG) policies and impact strategies). TA can also be used to support investees with adapting and implementing these policies through training and guidance to ensure effective implementation.
- **Verifying ILF:** Capturing outsized impact – At BII, while verification costs are typically covered through normal budgeting for ILF structures, TA can also be used for verifying impacts achieved or for conducting independent evaluations of ILF impacts when these may not be fully captured through agreed processes.
- **Enhancing ILF impacts:** Supporting end-customers – TA can involve business support services and capacity building in financial management, or ESG practices for customers of ILF recipients, for example, financial intermediaries providing financing to small and medium-sized enterprises (SMEs) or other business-to-business companies.

<sup>8</sup> See [GIINsight: Using non-financial support to increase financial inclusion](#) (GIIN, 2022)



## 4

### **Key findings from an early assessment of BII's ILF transactions**

This section summarises findings from the evaluators' assessment of the suitability and design of our ILF transactions, based on the Design Principles for ILF (described in the first section). Our ILF transactions are mostly recent (two-thirds were completed from 2022-2024) and are diverse in design. A summary of the ILF transactions assessed for this study and an example of one transaction is included below.

While in some organisations, approaches to ILF are centralised (e.g. established within a specific team handling blended finance and responsible for ILF strategies and policies) in our case, ILF deals have been led from across our capital pools and investment teams, based on investee need and opportunity. For example, approaches have been based on the opportunity to link impact goals to investees' existing compensation structures, or to tranches of planned investment or new platform investments. Some transactions have bespoke structures while others are adaptations of existing impact-linked incentive mechanisms. Our influence on transaction design also varied across deals, with some initiated by external parties (which we adopted) and others where we were closely involved in design. The evaluators found that while their level of sophistication varies, most of our ILF deals opt for simplicity rather than more complicated reward mechanisms. Where our Development Impact team was involved in ILF design (which is now standard practice), transactions were found to be better designed overall.

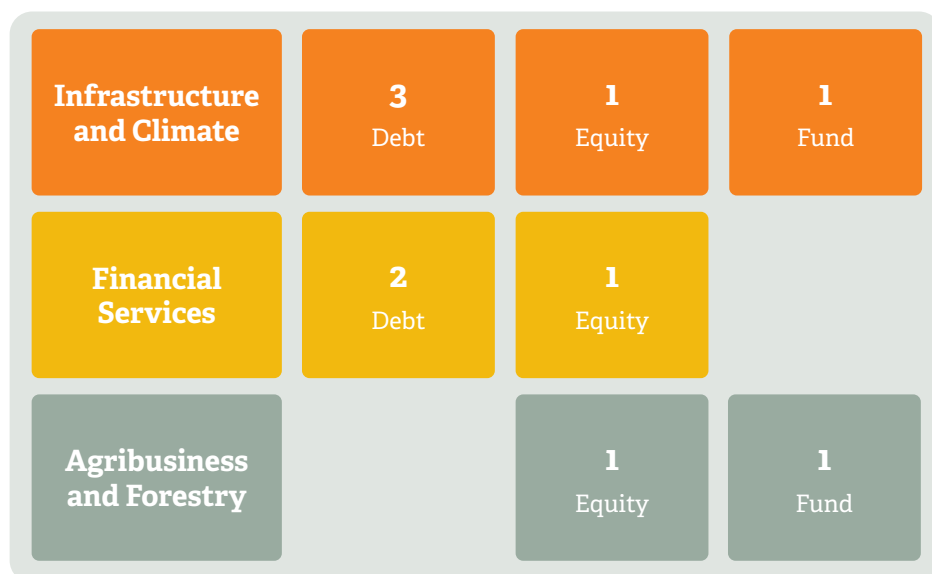


Figure 3: Sector and product type of BII ILF transactions assessed

### Example transaction: Growth Investment Partners (GIP)

Through the launch of GIP in Ghana in August 2022, we are investing \$50 million to establish a platform that provides long-term flexible capital (primarily in local currency) to SMEs in the West African country. SMEs in Ghana struggle to access the financing they need, particularly women-led businesses, despite Ghana having one of the highest rates of female entrepreneurship in the world. We are using long-term incentive plans to incentivise GIP staff to finance SMEs that generate a balanced blend of commercial and impact returns, influencing the shape of the portfolio. This includes ensuring women-led businesses access the capital offered by GIP through the inclusion of 2X targets.<sup>9</sup>

## What are we doing well?

### ILF Suitability Criteria

- Impact measurement in place
- Availability of baseline data
- Evidence supporting the impact thesis
- Feasible timeframe for impact creation

**Our ILF transactions broadly met the suitability criteria for ILF. Where they didn't, we used TA to help investees put prerequisite conditions in place.**

The evaluators found our ILF transactions generally met the suitability criteria for ILF: investees had impact measurement and management (IMM) systems in place, at least some baseline data was available for relevant metrics, and evidence supporting the impact thesis was systematically provided. Our investment strategy is rooted in impact creation and we systematically evaluate each investment opportunity<sup>10</sup> and its impact potential using tools such as the BII Impact Score.<sup>11</sup> The evaluators found this ensures our ILF transactions have the potential to create impact.

<sup>9</sup> See [Closing the gap: Lessons from six years of investing in women](#) (BII, 2024)

<sup>10</sup> See [What does impact mean to us? An overview of how we manage impact](#) (BII, 2023)

<sup>11</sup> See [Managing the impact of our portfolio: Our Impact Score](#) (BII, 2022)



With a range of investments (from more mature entities with sophisticated IMM systems to newly-established funds and companies) we sometimes provided tailored TA support to help investees build capabilities in impact measurement. Also, for newly-established funds and investment vehicles, we strategically selected management teams with relevant experience in impact management to ensure robust implementation.

Another key element of ILF suitability is whether the timelines of ILF targets are feasible. The evaluators found the timelines in our ILF transactions varied according to the context of the transaction, in line with ILF suitability criteria. They generally reflected a thorough consideration of the intended impact, the type of instruments being used, and the investee circumstances.

## **ILF Design Principles**

### **Choosing metrics and targets:**

- **Level of metrics (output vs. outcome)**
- **Link between incentives and impact performance**

### **Our equity investments' incentive schemes reward management for improvements at the outcome level as they occur.**

The evaluation assessed how well our ILF schemes were designed to incentivise or motivate investees. It focused on whether and how incentives continuously rewarded incremental improvements in outcome-level impact metrics. The evaluators found our investments were generally well-aligned with this Principle, with some exceptions. Notably, our equity investments performed better against this Principle than our impact-linked loan transactions. Debt transactions using tranching (releasing investment in stages based on meeting targets) or use-of-proceeds financing performed less well because they tended to impose binary, pass-fail targets. In these cases, the evaluators considered ILF could act more as a supportive measure to fulfil contractual obligations than as a catalyst for incremental improvements to impact. Designing incentives to include pricing reductions for reaching targets earlier or establishing rewards against a sliding scale (as done for our equity deals) would strengthen the link between incentives and impact performance. Nevertheless, loan tranching linked to impact targets offers a relatively straightforward and cost-effective way to structure ILF incentives.

Not every transaction can perform equally across each Principle, and this is due, to some degree, on the investment instrument used. Our degree of ownership and influence over equity transactions often justifies a more complex and bespoke ILF mechanism, which better rewards improvements against impact targets as they occur. The evaluators noted that because equity investments with management incentives generally involve higher transaction costs, and can be more costly overall than impact-linked loans, we have a higher stake in their success. In contrast, debt products with tighter margins (in which we may be one of many lenders, are time-bound, and for which we typically bear lower transaction costs) may benefit from a more standardised, simplified approach to enable greater scale-up across relevant transactions within our debt portfolio.

The evaluators also highlighted the difference in specialist input between our debt and equity ILF deals. First, management incentives in our equity transactions tended to be developed with the support of specialised consultants and other investors, bringing relevant expertise and diverse perspectives on what metrics to include. Second, our in-house impact professionals played an essential role in designing effective incentive structures for the equity deals examined. This highlights the importance of drawing on relevant expertise at the ILF design stage.

As mentioned previously, our ILF deals do not typically use concessional finance, as we believe commercial profitability must be achieved first to ensure impacts are sustainable. However, the evaluators cautioned that for the limited instances where we invest in pre-profit companies (for example, through our venture capital portfolio or through the creation of new platforms) our approach to ensuring commercial viability as a pre-requisite for impact may come at the expense of incentivising business managers in the early years of an investment. We address this by using cumulative metrics which consider impact performance across all years (including pre-profit years) once commercial viability has been achieved.

#### **Incentive alignment, structures, and governance:**

##### **– Incentive alignment**

**We emphasise co-creation in most of our ILF transactions, a strategic approach to ensuring incentivised outcomes align with the strategies of all stakeholders involved.**

In interviews for this study, our deal teams and management cited the close collaboration between ourselves and investees as a key success factor for our ILF transactions. In line with the Design Principles, the process of co-creation is crucial in minimising the risk that incentivised outcomes are peripheral (or irrelevant) to stakeholders and their agendas.

As this study focused on transaction design and deal terms, drawing on interviews with deal managers, it is not possible to provide a more comprehensive assessment of this aspect. However, one investee confirmed their ILF incentive's impact focus on climate finance aligned well with their own overarching sustainability strategy. While climate finance had been a priority for them for several years, ILF was used to reward implementing an even stronger focus on achieving climate outcomes.

##### **– Incentives to value creator**

**Our ILF transactions prioritise rewarding those central to the value creation process.**

Our ILF transactions were found to follow the principle of directing incentives toward the stakeholders most central to the value creation process. In practice, this means that when incentives were aimed at fund managers or intermediaries, the metrics used differed from those applied to individual companies. For example, while incentives for a direct investment in an agricultural enterprise can relate to increasing smallholder farmers' incomes, incentives for a portfolio of lenders to agricultural SMEs might be based on selecting and growing agri-businesses that target and benefit smallholder farmers.

##### **– Simplicity and transparency**

**Our ILF transactions emphasise simplicity in incentive structures and governance while adapting to specific investment needs and goals.**

Overall, the evaluators found our ILF transactions prioritised simplicity, ensuring investees could easily understand and calculate their rewards for achieving targets. Also, incentive schemes and governance structures were considered straightforward and transparent. Based on insights from interviews and documentation, none of the investment schemes appeared overly complex or opaque. However, equity (direct and intermediated) investments typically involved more intricate incentive structures and governance frameworks compared to impact-linked loans, to align with the specific needs and objectives of each investment. This points to the careful trade-offs required to select outcome-level metrics, maintain simplicity, ensure alignment between investor and investee, and costs. In equity transactions, advisory committees played a crucial role in shaping metrics and targets, highlighting our dedication to robust governance practices.

## What should we do differently?

The evaluators suggested various improvements we should consider, highlighted below.

### Pricing:

- **Fair, data-driven incentives**
- **Objective, context-specific pricing**

### **Develop consistent guidance for pricing ILF structures, supported by evidence.**

The evaluation explored the principles of (1) fair, data-driven incentives and (2) objective, context-specific pricing, which are both crucial to an ILF transaction's pricing strategy. Fair and data-driven incentives refer to incentives that effectively attract potential investees while ensuring optimal value for the provider of capital, following the principle of minimum concessionality. Objective, context-specific pricing involves considering initial costs required by the enterprise, economies of scale, synergies with the ILF targets, investees' ongoing operations, future strategy and the perceived or actual commercial and impact risks. Pricing remains one of the most challenging and least developed components of ILF market practice, because of the lack of evidence available.

Across both principles, our investments tended to receive lower ratings against the evaluators' assessment criteria. In the context of our equity investments, incentive amounts depend on commercial profits and are therefore unpredictable. Although this is typical of an equity structure, the evaluators flagged this could reduce their attractiveness for investees. In the context of impact-linked loans, most loan incentives included only a modest pricing reduction (given they were offered on commercial not concessional terms), raising questions about the overall appeal of the incentives for investees. However, there is currently a lack of evidence that a greater incentive (or more subsidy) leads to more impact.

While pricing decisions were based on competitive pricing and considerations of whether the incentive was sufficiently attractive (in common with the wider sector), the evaluators recommended we work towards a more scientific approach that would help substantiate whether incentives are priced effectively. This means model-based, data-driven, evidence-led pricing approaches (such as benchmarking similar lenders or using cost-effectiveness analyses) as part of our pricing strategies. Analysing empirical data on a large volume of ILF transactions and (in the longer-term) assessing the relative impacts achieved through varying pricing reductions could support assessments of cost-effectiveness and offer valuable insights for guiding ILF pricing strategy.

- **Additional impact**

### **Consistently consider the potential for additional impact in ILF transactions.**

The data available for this study and the recency of our ILF investments did not allow any conclusions to be drawn about the degree to which ILF led to additional impact for the 10 deals examined (above the impact already assessed as part of our investment process and approach to managing impact<sup>12</sup>). However, the evaluators found that, based on how the incentives schemes are designed, at least some additional impact can be expected for most of our ILF incentives. For some transactions, deal managers and impact professionals used peer data or baseline information to help set impact targets they believed were sufficiently ambitious. In some cases, they built in flexibility to adjust targets through regular reviews in the early years, in line with emerging good practice.

<sup>12</sup> See [What impact means to us](#) (BII, 2023)

In general, the evaluators found the extent to which additional impact is considered in the design of ILF mechanisms is largely driven by individual judgment, with no standardised approach in place. Interviews with our employees indicated that ILF's primary role has been to foster alignment of objectives between ourselves and investees. However, the evaluators noted there is a risk that incentives which are not sufficiently ambitious could be used to offer more competitive pricing.

The evaluators therefore recommended we should a) consider more consistently how ILF can serve as a framework to incentivise and enhance additional impact through centralised ILF guidance; and b) related to the recommendation on pricing, develop and apply standardised procedures for ILF, particularly for target setting and incentive pricing, to ensure ILF mechanisms generate additional impact where possible. For example, along with other practitioners, we have applied strategies such as market price bargaining, benchmarking, scenario projections, adaptive and flexible target setting, and learning from ex-post evaluations to ensure ILF mechanisms generate additional impact.

#### **– Guidance, verification, and evaluation**

##### **Use the findings from this study to inform our guidance on designing and structuring ILF transactions.**

The assessment emphasised challenges stemming from the absence of specific guidance and tools for effectively structuring and managing ILF transactions. ILF transactions were often found to have been developed in an ad-hoc or organic manner, with their level of sophistication often highly dependent on the expertise and experience of individuals. The early involvement of our development impact team in ILF transactions that followed good practices demonstrates the role they play in helping to guide deal teams. We have recently developed new guidance informed by the findings of this study.

##### **Generate more evidence to a) verify data provided by investees and b) rigorously evaluate the impacts of ILF.**

Currently, we don't have a consistent approach to ILF impact verification or commissioning independent audits of the data provided by investees. Only a few transactions are undergoing formal impact verification processes, although such processes are planned for other transactions once they mature. We are developing guidance which will reflect the importance of independent verification.

There is also a need for further evidence on the effectiveness of ILF structures in general to understand their role in driving impact performance and the circumstances under which they are most effective, drawing on investee perspectives. As most of our ILF transactions are still in their infancy, it was not possible for this evaluation to assess their impacts. Furthermore, the evaluation only focused on learning from internal perspectives within BII. An important focus of a comprehensive assessment should be on the perspectives of those ILF is targeting, the investees themselves. This evidence is crucial to inform our practices as well as industry standards.

Previous ILF research varies, from single case studies to theory-based impact evaluations, or focuses largely on outcomes-based financing which has distinct characteristics from the use of ILF in an investment context. A snapshot of the emerging evidence base on ILF is discussed in the next page.



## How do we know whether ILF works?

The ILF market is still in its early days, and results from rigorous evaluations are rare. There is a lack of detailed evidence on the effectiveness of different ILF structures and whether they work better in different contexts or specific sectors. However, a few studies from recent ILF programmes demonstrate promising results and lessons for practitioners:

- **Aceli Africa** offers incentives for commercial banks, non-bank FIs, and international social lenders to increase lending to agricultural SMEs. Initial results from their [Year 2 Learning Report](#) reported that **partner FIs have reinvested in their own capacity to orient lending towards greater impact**. Drawing on data benchmarking the loan portfolios of 35 lenders in Africa, they demonstrate that Aceli's lending partners are bucking regional trends in declining agricultural lending and are lending loans with smaller ticket sizes to reach underserved SMEs. Key enablers of success have included senior-level commitment from lending partners' C-suite and board, a clearly-defined agricultural lending strategy, and empowered middle managers. Alongside evaluation partners, Aceli is delivering a multi-year evaluation aiming to evidence longer-term direct and indirect effects of its incentives and capacity building efforts along the agriculture impact chain, from lenders to smallholder farmers and workers. The report describes Aceli's intention to more rigorously assess the additionality of financial incentives by randomising incentives to provide counterfactual evidence on whether they can reach new borrowers, encourage repeat borrowers, or improve lenders' loan terms. There is also an ambition to use the evidence gathered to understand the programme's value for money in future years.
- **A qualitative study** on IDB Invest's gender-focused performance-based incentives (PBIs) found **ILF incentivised partners to increase lending to women-led and owned businesses** and increase women's employment opportunities. The study included a case study review of seven IDB Invest clients across a variety of sectors (energy and infrastructure, corporates, and FIs) and geographies. Incentives were found to help shift internal mindsets and create demonstration effects to the wider SME lending ecosystem. Key practices enabling success included defining sector-specific impact theses, prioritising clients with an interest in gender, investing early in benchmark-setting and measurement processes, using transaction structures that rewarded intermediate and ongoing success, and using TA with incentivised investees, among others.
- The Swiss Agency for Development and Cooperation (SDC), IDB Lab and Roots of Impact **used ILF to attract private investment capital and scale high-impact social enterprises in Latin America** through the social impact incentives (SIINC) programme launched in 2015. SIINC transactions aimed to attract investors to investments with high social impact, but with a high risk of below-market rate financial returns. To address this, the programme offered social enterprises with impact-linked incentives contingent on achieving impact-related targets and mobilising funding from private investors. Its [evaluation](#) drew on mixed methods research from surveys, interviews, and field visits with implementing partners and social entrepreneurs. Root Capital, one agribusiness lender supported with impact-linked incentives for financing early-stage agri-SMEs, made loans to 32 businesses and estimated that over 9,500 smallholder farmers indirectly benefited from their transactions, earning \$24 million in additional income. They estimated a social return on investment of \$10-13 per one dollar invested by SDC and IDB. The study identified lessons about the importance of due diligence to avoid perverse incentives, measuring impact and value for money, and improving scalability.

One advantage of ILF transactions is that the outcome data collected for incentives can support a comprehensive assessment. However, measuring true impact additionality requires a valid comparison group, and long-term behavioural changes can be challenging to measure. Emphasising direct engagement with investees, and considering other process or theory-based impact evaluation methods on a case-by-case basis, can help balance costs and outcomes. A crucial first step is to develop a Theory of Change (ToC) that reflects how ILF can change investee behaviour, and what changes would be seen in investees and their customers or end users if ILF should be successful. For long-term structures, mid-term evaluations for generating timely, decision-relevant insights are recommended.

We believe evaluations are crucial for contributing to key evidence gaps in the ILF learning agenda, including (as a priority):

- How effective are ILF transactions in achieving their impact objectives and long-term behavioural change (such as practices to sustain or enhance impact within the investee organisation, and among other organisations); and
- Which ILF design features and pricing strategies are most effective, in what contexts, and for what types of investments.

Also, further research should expand the evidence base on:

- Key success factors and challenges during ILF design and implementation;
- How effectively ILF supports performance management and alignment between investor and investee over time;
- The extent to which ILF offers value for money considering the increased cost and complexity of ILF transactions;
- Unintended consequences of ILF, for example, a disproportionate focus on easy-to-measure impact metrics or creating perverse incentives; and
- Investee views and perceptions of ILF and the difference it makes.

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## Annex: ILF Glossary

### 1. Cost of capital reduction

**Impact-linked convertible:** A convertible note where the discount or cap on conversion depends on the achievement of predefined impact outcomes.

**Impact-linked guarantee:** A guarantee where the guarantee fee or the guarantee level depends on the achievement of predefined impact outcomes.

**Impact-linked loan:** Loans that incorporate rewards in the form of reduced interest rates depending on the achievement of predefined impact outcomes.

**Impact-linked matching fund:** Repayable funding made available to an enterprise that is (partially) forgivable depending on the level of achievement of predefined impact outcomes. Partial repayment is required only if the impact outcomes are not achieved. The enterprise is required to match the funding amount with a repayable investment.

**Impact-linked redeemable equity:** Redeemable shares where a portion of the shares can be redeemed at a pre-defined or discounted price dependent on the achievement of predefined impact outcomes.

**Impact-linked revenue share agreement:** A revenue share agreement (also called revenue-based loan) is a financing instrument where periodic repayments are based on a percentage of the revenues up to a predetermined return on the investment ('cap' or 'multiple'). Impact-linked rewards are provided by reducing the cap/multiple or the revenue share dependent on the achievement of predefined impact outcomes.

**Impact linked simple agreement for future equity (SAFE):** A simplified form of a convertible note that typically does not include regular interest payments. Similar to an impact-linked convertible note, the discount or cap on conversion of an impact-linked SAFE depends on the achievement of predetermined impact outcomes.

**Impact ready matching fund:** Non-repayable funding that rewards enterprises for building a robust impact measurement and management (IMM) system and elevating their IMM capacity. An impact-linked matching fund (IRMF) is a hybrid financial instrument with elements of impact-linked finance and capacity building, where the enterprise is required to match the maximum amount of funding with a repayable investment.

### 2. Management incentives

**Impact-linked challenge fund:** A challenge fund where the funder pays a premium or bonus dependent on the achievement of predefined impact outcomes.

**Impact-linked carry:** Impact-linked carry integrates impact targets into the calculation of carried interest. In private equity and venture capital, carried interest (carry) is usually part of the fund management fee structure and represents a share of the profits of the fund that a fund manager receives after certain financial targets (also called hurdles) are met.

**Long-term incentive plan (LTIP):** A company policy that rewards the management team or employees for achieving certain long-term goals. It can be linked to impact by incorporating impact objectives. In a typical LTIP, the employee, usually an executive, participates in dividends or an increasing company valuation through (virtual) shares.

**Origination incentives:** Payments that compensate lenders for the lower revenues and higher operating costs on small loans to businesses.

**Short-term incentive plan (STIP):** A company policy that rewards the management team or employees for achieving certain short-term goals. It can be linked to impact by incorporating impact objectives.

**Social impact incentives or performance-based incentives (SIINC):** A blended finance instrument that provides outcomes-based payments directly to enterprises raising investment. The level of payments depends on the achievement of predefined impact outcomes. SIINC is similar to performance-based incentives or results-based incentives. However, a SIINC requires the enterprise to close a financing round.

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