3.1 IMPACT-LINKED LOAN

Brief Description

An Impact-Linked Loan is similar to a traditional loan, with the main exception that interest rates (potentially even repayment obligations) are tied to borrowers' achievement of pre-defined and independently verified social outcomes. The enterprise receives "better terms for better impact". The higher the impact achieved by the impact enterprise, the lower the interest rate to be paid. In specific scenarios and contexts (e.g. particularly difficult market environment or crisis) additional loan forgiveness can be agreed upon for achieving additional pre-defined outcomes.

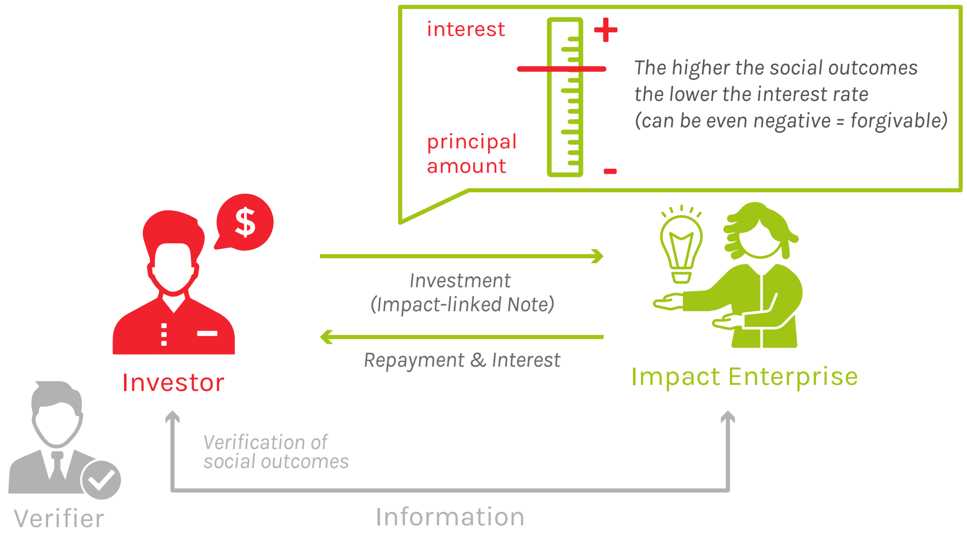

Figure 3.2 - "Impact-Linked Loan", source: Roots of Impact.

In other words, impact enterprises are encouraged to maximise their social outcomes, with financial rewards ranging from discounted interest payments to partial or even complete forgiveness of the loan repayment.

Overall, providers of Impact-Linked Loans are primarily motivated by impact (catalytic funders/impact-first investors), as they are expected to take lower returns due to the more favourable terms for the enterprise. However, there is the option for public or philanthropic funders to provide investors with a compensation to make up for the lower return (blended finance; see "Interesting variants and options" below).

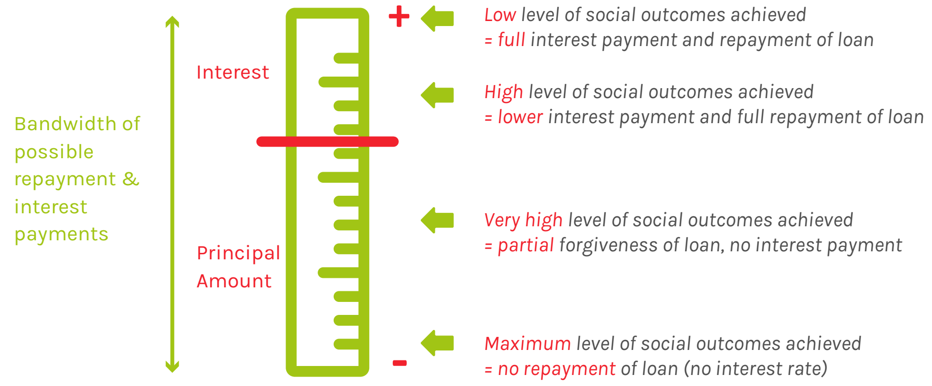

Figure 3.3 - "Interest, Principal and Impact created" source: Roots of Impact.

Purpose/Fit	High-impact enterprises gain access to loans with (highly) favourable terms and are incentivised to maximise their impact.
Can replace	Traditional debt, grants, and (other) blended finance instruments
Risk/Return Profile	n/a
Enterprise Lifecyle	All stages
Maturity	Various (but needs time to create positive outcomes)

Defining Criteria

- **Interest rate linked to impact:** Interest rate (and potentially repayment) is linked to direct and measurable impact, and follow the concept of better terms for better impact.

- **Financial reward for impact:** Rewards range from discounted interest payments to partial or even complete forgiveness of the loan repayment.

- **Incentive for impact:** Strong incentives for impact enterprises to outperform on positive impact.

- **Impact verification:** Independent verification of the achievement of pre-defined outcomes.

- **Term maturity:** Impact-Linked Notes have usually longer tenors (~3-5 years) than traditional loans.

- **Impact-Return trade-off:** Investors are primarily motivated by impact (catalytic funders/impact-first investors) as they are expected to take lower returns, unless they are compensated by an outcome funder.

Interesting Variants and Options

- **Impact-Linked Loans with compensation by public or philanthropic funder:**
  - Public or philanthropic funders can provide investors with a compensation to make up for their lower returns resulting from more favourable terms for the enterprise (blended finance).
  - In addition to compensating for lower returns, they can provide capital in form of grants, which can be used to reduce investment risks for investors, e.g. by (partially) covering first losses.
  - Parts of the grants provided to impact investors to compensate for the lower return can be used by the lender for zero-interest loans. The combination of non-interest-bearing capital from donors with the impact investors' interest-bearing capital, lowers the total interest rate to be paid by the impact enterprise.

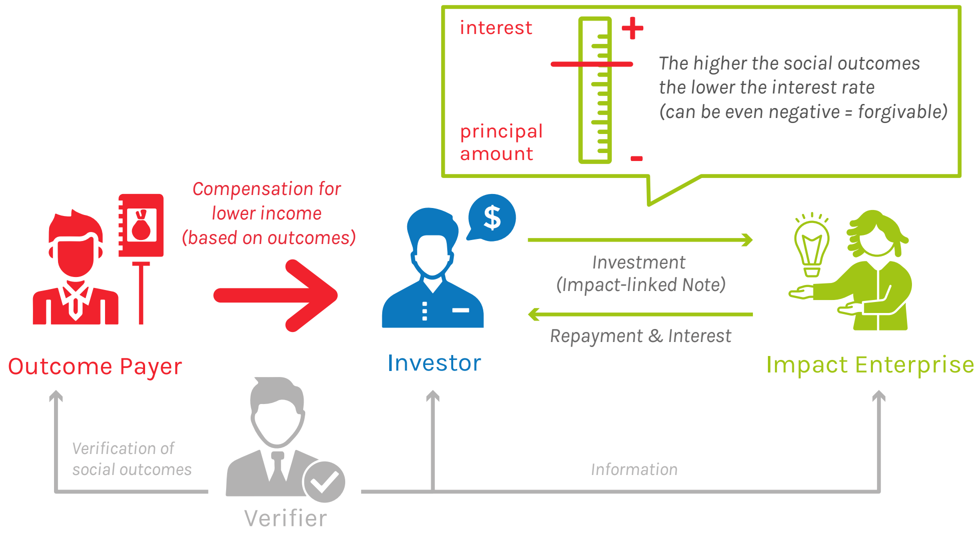

Figure 3.4 - "Impact-Linked Loan with compensation by public or philanthropic funder", source: Roots of Impact.

- **Impact-Linked Convertible Loans:**
  - Once a pre-defined trigger (e.g. qualified equity round) is reached, the loan (fully or partially) converts into equity.
  - The discount applied depends on the impact performance – the higher the impact the lower the discount.

- **Impact-Linked Revenue-Share Agreements:**
  - Within a pre-defined range (regular rule-based adjustment), the level of revenue share is linked to the social enterprises' impact performance – the higher the social outcomes, the lower the revenue share or the total amount to be paid back (e.g. reducing the multiple).

Example of Impact-Linked Loans structures:

- Impact-Linked Loans: The Impact Investment Group provided a USD 407,000 loan to the impact enterprise Xceptional, with the clause that the more social impact the job placement firm working with people with autism delivers, the more their overall repayment is reduced. As target outcomes they look at the number of people placed in high-quality roles, their job satisfaction and happiness. Other key terms included a grace period at the start of the loan period, when no cash repayments are due.

- Impact-Linked Loans with compensation by public funder: The "impact-first" investor Open Road Impact Fund with support from the Swiss Agency for Development and Cooperation (SDC), provides emergency loans (generally <USD 100,000) to impact enterprises in Latin America and the Caribbean responding to the Covid-19 crises. SDC has made grants available, used for zero-interest loans, lowering total interest to be paid by impact enterprises and partly covering first losses. If not used to cover losses, and if certain impact targets are met, impact enterprises need to pay back only part of the capital.

Examples of relevant terms (as formulated in a contract):	
Loan amount	The Financing Amount is (USD 300,000) in aggregate principal amount of Impact-Linked Loan.
Impact performance index:	• Pre-agreed weighting of up to (three) pre-defined impact KPIs form an index for impact performance. • Index ranges from (0) to (>=120) with reduction of interest rate (total reduction at maturity retrospectively) ranging from (0%) to (3.2%).
Interest rate	• The Impact-Linked Loan will accrue interest at a rate (per annum) of maximum (6%). • Maximum interest rate p.a.: (6%) • Minimum interest rate p.a.: (-10%) (partly debt forgiveness) • Example: if the impact performance equals to (110) (indexed), the p.a. interest rate is reduced by (2.9%)

Main Advantages

- High-impact enterprises have access to concessional loans and some of the (re)payment burden is lifted according to the impact they create.
- Impact enterprises are incentivised to increase and outperform on their impact.
- Avoid mission drifts, allowing impact enterprises to scale without having to compromise on their social values and outcomes.
- More favourable loan terms can unlock more resources, i.e. leverage private sector capital.
- Meets the needs of high-impact enterprises and aligns investor and investee's interests.

Main Challenges

- There are few investors who are willing (and able due to fiduciary duties) to sacrifice financial returns for higher levels of impact.
- Public and philanthropic funders are not used to compensate private investors for the losses that come along with more concessional terms.
- The financial rewards must be carefully determined in order to find the right balance between (a) appropriate incentives for impact enterprises to keep their focus on impact, and (b) not providing an unnecessary level of subsidies.
- Internal as well as external regulations.

Case studies and additional resources about Impact-Linked Loan can be found here.