Study on the development effects of debt funds

High-level findings on debt fund managers' approaches to impact management and identification of opportunities for more effective and efficient impact analysis on debt funds by DEG and OeEB

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STUDY ON THE DEVELOPMENT EFFECTS OF DEBT FUNDS

High-level findings on debt fund managers' approaches to impact management and identification of opportunities for more effective and efficient impact analysis on debt funds by DEG and OeEB

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German development bank DEG and the Development Bank of Austria OeEB commissioned a study with a cross-comparison on how debt funds that are financed by them generate and measure development effects. The focus of the study is twofold: exploring synergies and differences on how debt funds generate and measure development effects; and (ii) supporting DEG and OeEB in identifying opportunities for a more effective and efficient approach to capturing the impact management approaches and actual development effects of debt funds. The findings are based on a desk review of fund reporting on impact management and results as well as a series of interviews with experts at DEG, OeEB as well as fund managers, fund advisors and entities representing 70% of DEG and OeEB's invested capital in debt funds. This means that the scope is biased by DEG/OeEB selection criteria and does not allow conclusions on debt fund market as a whole, but only for those in our respective portfolios. Steward Redqueen is responsible for all analysis, findings, and recommendations in this report.

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Debt funds as vehicles for generating development effects

Debt funds are an important vehicle to help drive both development finance and private institutional capital in emerging markets and developing countries. Investing in debt funds has specific benefits over direct investment and indeed also over private equity funds.

On the risk/return side, benefits include more regular cash flow, lower volatility, and a relatively stable returns profile. In addition, debt funds tend to have much larger portfolios compared to private equity funds, which increases the spread of investment scope and impact and decreases risks.

Table 1 - Key characteristics of private debt vs. private equity funds

	Private debt funds	Private equity funds
Risk profile	Lower	Higher
Return potential	Lower (mostly interest payments)	Higher (mostly investment appreciation)
Control/influence	Limited to no direct influence over the management and strategic decisions	Active role in management and strategic decisions
Liquidity	Shorter term, less illiquid	Longer term, highly illiquid
Fund life	10-30+ years, terms for investors vary	10-12 years
Exits	Maturity of loans	Negotiated exits through IPO, sale etc.

On the impact side, debt funds can help de-risk some of the more difficult to reach geographies, sectors, and themes by combining the inherent lower risks of debt investments with the larger pooling of investments and, in some cases, lowering investment risk in blended finance structures. These are often the areas where development interventions are most needed and therefore produce the greatest impact. Debt funds also specifically facilitate smaller ticket investments to end-clients, which help development finance institutions (DFIs) reach both a larger number and a wider range of end-beneficiaries compared to direct financing.

These factors make debt funds a particularly suited vehicle for blended finance models, where governments and DFIs leverage capital from commercial financiers with lower risk appetites yet a commitment to support impactful companies and projects.

On DEG and OeEB's focus on debt funds

DEG and OeEB's combined debt fund portfolio consists of almost half a billion euros in commitments to 17 different impact-focused debt funds. For OeEB, investing in debt funds has always been an integral part of their strategy, and debt funds represent about 30% of OeEB's portfolio. For DEG, a focus on debt funds is more recent and represents just under 1% of the Bank's total portfolio.

The collective portfolio is predominantly focused on renewable energy and sustainable infrastructure (40%), followed by financial inclusion (36%), and agriculture & aquaculture (24%). The debt funds' outreach is mostly focused on regions with higher investment difficulty and thus higher levels of additionality in the market. There is a clear emphasis on Africa (13 funds) and Latin America and the Caribbean (7 funds). The funds are managed or advised by a total of 12 different fund managers.

DERa and its application to debt funds

DEG and OeEB ('the Banks') both use the Development Effectiveness Rating (DERa). The DERa is a model and impact management system that structures and quantifies the development effects of (potential) investments. It rates individual clients' contribution to development effects and follows up on changes in performance since DEG or OeEB's investment. Based on the DERa assessments, DEG and OeEB can compare the contribution of investments to their impact objectives, steer the overall development quality of their portfolio, and build their impact reporting. The DERa has been in use since 2017 and is currently in the process of being updated to a 2.0 version. This new version aims to reflect updated impact priorities, introduce a methodology that includes negative and positive impact scores on indicators, and become more user-friendly to the Banks and their clients. Both OeEB and DEG have experienced that applying the DERa to debt funds tends to be more complex than their other investments and comes with specific challenges. That is why the Banks jointly commissioned a dedicated research study into the development effects of debt funds.

Impact measurement and management approaches of debt funds

The first focus of the study was exploring synergies and differences on how debt funds generate and measure development effects. The analysis is primarily based on fund documentation for 17 invested by DEG and OeEB, and interviews with seven debt fund managers.

All debt fund managers in OeEB's and DEG's portfolio are intentional about their impact and assessing the social, environmental, or developmental outcomes associated with their investments. Compared to the market, DEG and OeEB's debt funds are much more intentional about their impact objectives. Indeed, most funds officially consider themselves an Article 9 'dark green' fund under the Sustainable Finance Disclosure Regulation (SFDR), meaning that they are a fund with sustainable investment as a prime objective.

Impact measurement and management practices

Across the board, several key elements to measuring and managing impact are observed:

- **Impact objectives**: 100% of analysed funds have defined impact objectives, where they identify specific social or environmental goals aligned with the fund's mission and investment strategy. All funds also have some form of structural approach that explains how their activities lead to impact objectives, mostly using a Theory of Change or logical framework, although these explanations are often internal and not externally published;

- **Impact KPIs**: 100% of funds have established impact metrics and KPIs, which include generic KPIs (e.g., job creation) and mission-specific KPIs (e.g., GWh renewable energy produced, number of borrowers reached, metric tonnes of food produced). The indicators tracked in internal systems are often more extensive than reported results;

- **Alignment with SDGs**: 100% of funds align their mission with the SDGs, although the extent to which actual results are linked to the SDGs differs: some funds only mention the SDGs they aim to contribute to, others also link actual impact results to SDGs or SDG targets. For example, one of the consulted fund managers includes a public overview on their website on how concrete impact results link the relevant SDGs

- **Impact in investment processes:** 100% of funds conduct due diligence on potential borrowers to assess their environmental, social, and governance (ESG) practices, and have screening criteria for potential investments that are linked to an impact thesis. Impact considerations are also integrated into the investment decision-making process, although the funds generally do not yet have a dedicated impact expert in the IC, but rather an IC member that has impact as one of their angles;

- **Impact reporting**: 100% of funds provide regular impact reports to their investors, mostly with key impact KPIs included in quarterly reports, and in annual ESG and/or impact reports. These reports highlight results, progress made toward impact goals, challenges encountered, and lessons learned. 59% of fund managers also publish fund-specific impact or sustainability reports on their website, while 29% publish impact stories or briefs and 12% publish a fund-wide impact report;
- **Verification**: 76% of funds are signatory of the Impact Principles and engage third-party impact assessors or auditors to independently verify and validate the impact management approach. This external verification adds credibility to the impact measurement process;
- **Evaluations**: Some fund managers have also commissioned independent evaluations of the performance and results of their funds, which are mostly internal, and focus on accountability to investors and lessons learned for the manager. These can be evaluations of individual funds, or thematic evaluations on business model of structured funds.[1]

Standards

Debt funds often align with specific frameworks and standards related to environmental, social, and governance (ESG) and impact factors. These vary by purpose and theme. Nearly all funds are members of the Global Impact Investing Network (GIIN), which is used as a knowledge hub and networking platform. Several fund managers align their impact management approach with the Impact Principles[2], including independent verification. In due diligence, the IFC Performance Standards (PS)[3] are applied, with further consideration of the core conventions of the International Labour Organisation for employment aspects. In addition, there are several theme or sector focused initiatives that provide harmonised indicators to measure performance aspects. These include the 2X Challenge[4] on gender, or the Social Performance Indicators (SPI) 4[5] on social performance. Many fund managers also align their impact metrics with the UN Sustainable Development Goals (UN SDGs), most notably in their impact reporting. More recently, the introduction of the Sustainable Finance Disclosure Regulation (SFDR) has been a significant development.

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[1] An example is a Deval's study: *Structured Funds. A Balancing Act between Financial Sustainability and Development Impact* (2020).

[2] The Impact Principles are a framework for investors for the design and implementation of their impact management systems, ensuring that impact considerations are integrated throughout the investment lifecycle. They may be implemented through different types of systems, each of which can be designed to fit the needs of an individual organization. They do not prescribe specific tools and approaches, or specific impact measurement frameworks. The expectation is that industry participants will continue to learn from each other as they implement the Impact Principles. For more information see: https://www.impactprinciples.org/

[3] The Performance Standards provide guidance on how to identify risks and impacts, and are designed to help avoid, mitigate, and manage risks and impacts as a way of doing business in a sustainable way, including stakeholder engagement and disclosure obligations of the client in relation to project-level activities. For more information, see: https://www.ifc.org/en/insights-reports/2012/ifc-performance-standards

[4] The "2X Challenge" is a commitment by investors to collectively mobilise private sector investments in developing country markets focused on providing women with improved access to leadership opportunities, quality employment, finance, enterprise support, and products and services that enhance economic participation and access. 2X Global is an affiliated community that includes impact debt fund managers involed in advancing intersectional investment agendas, scale the field, shift mindsets, and facilitate capital deployment. For more information, see: https://www.2xchallenge.org/

[5] The SPI–Social Performance Indicators –is a social performance assessment tool for financial service providers (FSP). The SPI allows FSPs evaluate their level of implementation of the Universal Standards for Social Performance Management, including the Smart Campaign Client Protection Principles. SPI also offers users with a specific mission focus (e.g., green, poverty, gender) to assess their practices, thanks to optional indicators that reflect the latest industry thinking in these areas. For more information see: https://cerise-spm.org/en/spi4/

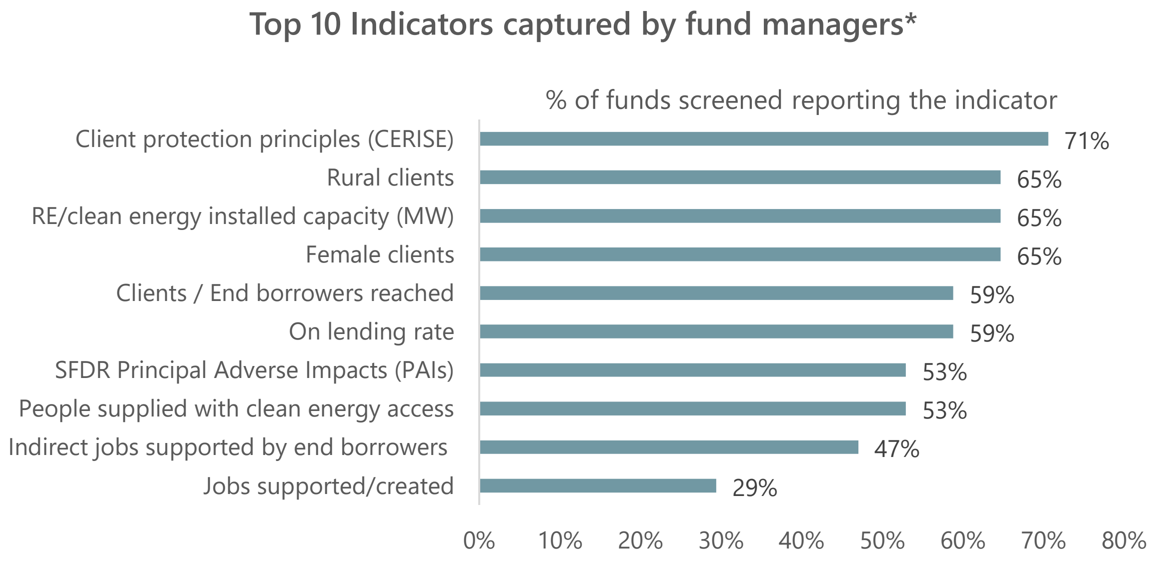
On the SFDR for debt funds

SFDR is a transparency framework put in place by the European Union (EU). The SFDR requires financial market participants and financial advisers to disclose information about ESG aspects of their investment products. Since 2023, funds that have sustainable investment as its objective (so-called Article 9 or 'dark green' funds) are required to report on a set of Principal Adverse Impact (PAI) indicators in a statement on their website and describe PAI in pre-contractual information. PAI relates to negative effects on sustainability both at entity and product level, and concern 14 climate, environmental, social and governance metrics. Since its introduction last year, 82% of the Banks' invested funds report against SFDR. The only three funds that do not report against SFDR are all based in and focused on debt Latin America and are thus not directly obliged to comply with SFDR. However, it is likely that these funds will be requested by European investors to either report all or selected relevant PAIs in the future. The introduction of this statement has been perceived as intensive by fund managers but has driven further harmonisation of key indicators.

Data collection

Fund managers usually collect their impact data primarily at two stages: first at the due diligence stage of an investment for a new client, and then on a semi-annual and/or yearly basis for reporting. Impact data is generally reported in quarterly reports to investors as well as annual impact or ESG reports, and bilaterally through investor requests. The analysis of indicators used by debt fund managers shows that they often collect slightly different versions of the same indicator, with different terminology or methodologies used to capture the same content.

In their impact measurement, debt funds face specific challenges in capturing development effects. Debt funds tend to have a greater number of borrowers when compared to investees of private equity funds. This can make impact monitoring and measurement trickier as fund managers have a greater data collection burden for the same indicator framework. In addition, given the smaller average investment size and the nature of the borrower-lender relationship, debt funds have less leverage over the borrowers' activities than equity funds for their investees. The amounts used from borrowing are also less likely to be used for operational costs such as salaries and more likely to be dedicated to a particular product offering on the end borrowers' side.



[6]

Alignment of debt fund impact data with the DERa

The second focus of the study was supporting DEG and OeEB in identifying opportunities for a more effective and efficient approach to capturing the impact management approaches and actual development effects of debt funds. To identify these opportunities, feedback on DEG and OeEB's current approach was collected among debt fund managers, primarily on the alignment of their impact management systems and the DERa as well as perceived operational and methodological challenges. The main findings and views are provided below, followed by recommendations for potential measures DEG and OeEB could take to make their data collection and impact analysis of debt funds more meaningful, reliable, and efficient.

Key findings show that:

- Debt funds generally align with DERa 1.0 on employment, gender, and financial metrics, but face mismatches in thematic areas, creating the need for tailored indicators. Data quality gaps stem from mismatches with DERa's requirements.
- Fund managers struggle with the evolving demands of various stakeholders, inconsistent definitions/measurement units, and inefficient data collection processes, highlighting the need for a unified reporting template and clearer guidance.
- The DERa methodology and its current sample approach faces challenges with generalisability and the burden of standardized frameworks not fitting fund objectives.
- Opportunities for DERa 2.0 include better alignment with investment themes, international standards, and a focus on fund manager approaches to enhance data quality and operational efficiency.

Alignment and gaps on data

Within the impact management systems of the debt funds, there obviously is variation in the data they are collecting, mostly driven by the thematic impact focus of the fund. However, in general teams, there are some

[6] *Underlying data for this analysis comes from a review of fund manager documentation and was supplemented by bilateral interviews. Therefore, it is not a complete overview of the exhaustive list of indicators captured by fund managers. In addition, fund managers for whom an indicator was not relevant or applicable were counted as capturing that indicator, to give a balanced overview of the top indicators captured.

areas of alignment between the indicators requested by the current DERa version ('DERa 1.0') and the indicator frameworks of the Banks' partner debt fund. These mostly concentrate in three common areas of interest: employment (e.g., the number of jobs supported or created), gender (e.g., the share of women in the workforce) and key financial performance indicators (e.g., turnover, profit after taxes, revenue, salaries).

At the same time, there also is a perceived partial mismatch between the DERa data requests and the core indicators that the fund managers track and steer for. The DERa includes indicators that are typically not tracked in funds' impact monitoring systems which means that these need to be collected individually and manually from borrowers by the fund manager. Debt funds have different thematic objectives (e.g., financial inclusion, renewable energy) and instruments (e.g. infrastructure versus financial institutions) and therefore require more tailored indicators beyond what DERa 1.0 requests.

The indicators that exhibit the most gaps often arise due to a mismatch between the informational value perceived by the funds and the prerequisites of the DERa, which has in practice often led to insufficient or low quality data. Across the five DERa categories (i.e., "decent jobs", "local income", "market and sector development", "environmental stewardship" and "community benefits"), the local income category tends to have the largest gaps in accurate data returned. Fund managers highlight the greatest data challenges relate to procurement and interest expenses, capital expenditure, direct and indirect local income generation and share of national shareholders. The community benefits category also generated challenges, as most fund managers were not capturing information on the proportion of profits that portfolio companies or partner FIs were spending on corporate social responsibility (CSR) activities.

At the same time, the DERa 1.0 is missing out on opportunities for relevant indicators that have been harmonised over the last few years since the introduction of DERa 1.0. Many debt fund managers are seeking to align their data collection and disclosure practices with international standards such as the 2X criteria and comply with SFDR to anticipate investor requests and improve their credibility as a debt fund manager. Related indicators are not currently incorporated into the DERa but captured in different tools at the moment. These will be combined in DERa 2.0.

Consequently, the study identifies three overarching opportunities for increased alignment in an updated version of the DERa ('DERa 2.0'): (i) tailoring indicators based on the investment type or theme; (ii) incorporating indicators that align with external international standards; and (iii) including more indicators that focus on the fund manager's approach.

Operational challenges

Fund managers are legally obligated to provide the information requested for the DERa on an annual basis. However, the Banks' impact teams noted that enforcing this is often challenging due to factors such as added burden, constrained capabilities and resource, and insufficient guidance.

It was clearly noted that the level of burden on fund managers is significant – and increasing annually. Fund managers are often at the behest of multiple shareholders and debt providers. These often include government entities, (E)DFIs and MDBs from which they receive different data requests. These can also change year on year, meaning that previous data collection approaches can become obsolete.

Specifically, for EDFIs, there still is a perceived lack of harmonisation of definitions and units of measurement, despite the major progress and achievements on harmonisation, such as through the Harmonised Indicators for Private Sector Operations (HIPSO) initiative. There still are opportunities to strengthen alignment in the way that DFIs ask for harmonised indicators, in terms of unit of measurement, disaggregation and the type of indicators that are asked.

In addition, an even larger perceived issue than indicators harmonisation is the data collection process, where each EDFI has its own template for data collection. Fund managers clearly expressed the desire to have a common reporting template, ideally linked to a joint data portal so that clients only need to insert data once. Such a solution would put an end to significant inefficiencies in the current reporting landscape of inserting the same information several times in different formats and templates (e.g., excel, word, or web-based).

Finally, the majority of fund managers consulted felt they had not received sufficient guidance on how to complete the DERa input sheet, the rationale for including specific indicators or best practice on collating the information. This lack of clear and standardised definitions can create varying quality in the data received.

Methodological considerations

Fund managers as well as impact management focused experts within the Banks' reported that the current methodology creates challenges. First, the sample approach[7] results in a lack of generalisability. Second, the overly standardised frameworks do not accommodate the funds' own investment objectives. Third, reporting at the investee level adds a reporting burden.

Recommendations

The conclusions above show that the existing version of the DERa was not sufficiently tailored to and suited for effective and efficient application to debt funds. This means that reliable insights on the development effects of debt funds are hampered by data availability, data quality and methodological issues. Based on the findings and inputs from OeEB, DEG and fund manager experts we have come to the following recommendations. Based on these recommendations, a suggested framework of key indicators for DERa 2.0 for debt funds has been developed (see Appendix A).

1. **Prioritise data quality and availability over quantity.** Moving forward, data availability and quality should be prioritised to get reliable and meaningful insights. This means that indicators that have limited relevance and/or practical challenges for debt funds and as a result deliver unreliable data should be discontinued (e.g., procurement, % local, interest expense to local banks, annual spending on community development, greenfield, capex).

2. **Request data at fund aggregate and fund manager instead of individual investee level.** To reduce the burden and increase data availability DERa 2.0 should request reporting at investee level as little as possible and instead focus on fund aggregate or fund manager level. As scoring was based on averages and reporting on totals, this should not fundamentally affect the DERa results.

3. **Harmonise indicators with international standards.** To reduce the burden on fund managers and increase data availability, quality and comparability, the DERa 2.0 should align as much as possible with existing sustainability and impact-related standards. This should mostly focus on the Sustainable Finance Disclosure Regulation (SFDR), but also thematic standards such as the 2X Challenge for gender and sector-specific such as Social Performance Indicators (SPI) 4 and the Client Protection Principles (CPPs) for microfinance.

4. **Strengthen alignment of impact indicators with the fund's characteristics and objectives.** As the DERa is a largely standardised indicator framework fund managers justifiably question whether it adequately captures key development effects. The link between the fund's objectives and the DERa should be further bolstered. This can be done by maintaining core indicators but supplemented with tailored

[7] The 'sample approach', where fund managers with large portfolios (over 10 borrowers) are allowed to provide data on a sample of 10-15 clients. Although this limits the level of effort for fund managers, the total and average development effects generated for the DERa are by definition inaccurate. Additionally, reporting at an investee level can impose heavy burdens on fund managers and their clients, particularly for indicators that typically are not captured in the impact management systems of funds.

indicator modules per investment type (corporate, FIs, infrastructure) and per key sector/theme (MSME finance, climate). A tailored "fit for purpose" approach would also improve the quality of the data.

5. **Adapt input sheets requests for fund type/theme**. Related to the tailored modules, the input sheet should be tailored for investment type and theme, developing an indicator framework with a 'core' module and a set of adjustable modules which can be adjusted based on the fund sector focus and theme.
6. **Add a focus on fund manager approach:** in line with the approach for DERa 2.0 for private equity funds, it is suggested to add indicators on the ESG and impact approach and performance of the fund manager. Performance aspects to include whether the fund has impact objectives, a climate strategy and carbon accounting approach in place, and how it has embedded ESG and impact into day-to-day investment operations (e.g., investment criteria, dedicated staff and IC members, management systems).
7. **Create a common template, and ideally, a joint data reporting platform among EDFIs.** There is consensus among fund managers that there are major inefficiencies in the data requests by the European Development Finance Institutions (EDFIs). A list of common indicators is a basic step, but if these common indicators are still requested in different ways by different DFIs, it would not help to solve the problem. A shared platform would enable fund managers to provide an agreed upon set of information just once, in one format which would be accessible to all EDFIs. DEG and OeEB are encouraged to further prioritise ongoing discussions and efforts in the EDFI working group on this issue.
8. **Ensure there is a clear communication on indicators, definitions, rationale and use of DERa data.** In the communication of DERa 2.0, DEG and OeEB should clearly explain what data is required, including the definitions and units of measurement to avoid misinterpretation. Moreover, fund managers would benefit from further explanations on the rationale for the five impact categories, and how DEG and OeEB use the DERa results in internal processes and reporting. This can be done through a short manual, a webinar and/or an introduction video.
9. **Actively share best practice methodologies with clients**. To reinforce inefficiencies in reporting, leading to the development of different methodologies and duplicating efforts on finding workable solutions, DEG and OeEB are encouraged to actively share best practice methodologies with clients. Examples are indirect job estimations or GHG accounting, particularly in cases where this must be estimated based on modelling.

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Suggested indicator structure for debt funds and their integration into DERa 2.0

The proposed revision of DERa maintains the five key categories – general client data[8], employment and decent work, local income, market and sector, environmental effects and community contributions – but also considers modular components based on investment type and theme. The structure of the updated DERa is visualised in the Figure below and outlines the key indicators for the core module, investment type and theme.

CORE

Decent jobs
- Current number of jobs
- Annual change in direct jobs supported
- Good labour and working conditions
- % women in senior management
- % women in workforce

Local income
- Profit after taxes
- Salaries
- Payments to Government

Market and sector development
- Country and sector score

Environmental stewardship
- Non-renewable energy consumption and production
- Emissions to water
- Hazardous waste / radioactive waste ratio

Community benefits
- External grievance mechanism in place

INVESTMENT TYPE

Corporates
- Environmental and social management system (ESMS) in place
- Direct carbon footprint (scope 1-2 and sequestration)
- GHG intensity of investee companies
- Activities negatively affecting biodiversity
- Resettlement

Infrastructure
- Environmental and social management system (ESMS) in place
- Direct carbon footprint (scope 1-2 and sequestration)
- Greenhouse gas intensity of investee companies
- Activities negatively affecting biodiversity
- Resettlement

Financial institutions (FIs)
- Environmental and social management system (ESMS) in place
- FI portfolio emissions (scope 1 and 2)

THEME

Medium and small-sized enterprises (MSME) finance / financial inclusion
- Client protection principles
- Number of borrowers reached
- Number of borrowers reached by category
- Share of borrowers reached by category
- Average loan size to end clients

Renewable energy
- Gigawatt hours produced (incl. non-renewable)
- People served with energy

Agriculture/food
- Sustainable and efficient land/ agricultural practices
- Certification in place
- Food and food related products produced and delivered

[8] This has been split into fund and fund manager level.