MORRISON | FOERSTER

Impact Investing
and
Green Bonds

June 2014

Impact Investing

- Investors have become more keenly focused on aligning their investments with their social and environmental goals
- Investors may include
  - Those who use impact as a part of their diligence and as an opportunity to improve company performance
  - Those who require both impact and financial returns
  - Those who only invest in companies that have a positive impact and may be willing to take a lower return in exchange for a strong alignment with objectives
- Require measurement and reporting
- Impact investors also often require different terms in connection with their equity investments
  - Redemption right for mission drift
  - Separate class of stock particularly for foundation investors
  - Protective provisions for mission
  - Request of use of new corporate forms

Reporting Mechanisms

- "Sustainable" and ESG ratings agencies and ratings systems provide a mechanism to assess the environmental, social and governance impact of a particular company
- Standardized ESG ratings attempt to assess the level of a company's success in achieving its intended environmental, social and governance impact
- A number of different ESG rating agencies exist
  - Some examples include: Vigeo, EIRIS, MSCI, Sustainalytics, Oekum
  - There is no universal standard rating system, and some ratings may be applied to a company irrespective of its organizational structure
  - None provide a viable means for verification of information or audits of the type performed by accounting firms for public companies other than the Sustainable Accounting Standards Board (SASB)

Reporting Mechanisms (cont'd)

- Public Companies – Voluntary reports
  - Sustainability Reporting Guidelines contain recommended performance indicators and management disclosures that organizations may adopt voluntarily
  - Used as the basis for producing voluntary corporate social responsibility (CSR) or sustainability reports
  - GRI is not a rating agency; it doesn't monitor whether a particular company has correctly applied its guidelines, and doesn't provide certifications
- Private Companies
  - B Lab is a non-profit company that has established a certification process designed and used primarily by private companies to create "B Corporations"
  - Designed to measure the impact of a company on all of its stakeholders
  - The standards change depending on the size of the company and the sector in which the company operates

Reporting Mechanisms (cont'd)

- Impact Reporting and Investment Standards (IRIS)
  - Developed by Global Impact Investing Network (GIIN), a not-for-profit organization dedicated to increasing the effectiveness of impact investing
  - Provides a standard set of performance measures for describing environmental, social and governance performance, including a variety of performance objectives, as well as specialized metrics for a range of industry sectors
  - IRIS is not a rating agency and does not provide certifications
- Sustainable Accounting Standards Board (SASB)
  - The desire for integrated sustainability accounting standards led to the creation of the new SASB, a registered 501(c)(3) non-profit organization, accredited by ANSI
  - Creating industry-specific sustainability accounting standards to disclose ESG (environmental, social, and governmental) factors in standard filings for public companies, such as the Forms S-1, 10-K, 10-Q, and 20-F

Green Bonds

What are they?

- Green Bonds might be thought of as a form of socially responsible investing (SRI)—aligning investor interest in environmentally-sound projects with their desire to invest in fixed income securities
- There is no uniform definition of a “Green Bond” but it is generally thought of as a debt security the proceeds of which have been earmarked for use in special projects that advance environmentally-friendly objectives
  - Investments in renewable energy, energy efficiency, climate-friendly projects
- From a legal perspective, a “Use of Proceeds” Green Bond is a traditional (usually) senior debt obligation of the issuer that pays a coupon but it is distinguished by the specificity of the use of proceeds

Types of Green Bonds

- Use of Proceeds Bond – traditional debt security the proceeds of which are earmarked for use in advancing certain eligible investments
- Revenue Bond – non-recourse to the issuer; the credit exposure is to pledged cash flows of the revenue stream. Proceeds are ring-fenced or tacked by the issuer and tied to the issuer's investments in the project
- Project Bond – for single or multiple projects, where the investor has direct exposure to the project
- Asset-Backed Bond – collateralized by one or more specific projects

How has the market developed?

- Beginning in 2007/2008 supranational entities, such as the European Investment Bank and the World Bank, began to issue green bonds wherein the proceeds world be used to fund climate or otherwise environmentally friendly projects
- There has been an evolution in the market:
    - Issuers have started to come to market with $1 bn-sized transactions instead of $10mm-sized transactions
    - Now, in addition to supranationals or quasi-governmental issuers (World Bank, EIB, IFC, EDF, KEXIM) corporates have begun to issue green bonds.

How has the market grown?

- There has been significant recent growth
  - 2012 – issuance of nearly $3 billion
  - 2013 – issuance of nearly $12 billion
  - 2014 – expected issuance of between $25 – 40 billion
- Green bonds have been issued in a range of currencies
  - USD and EUR are the most popular currencies
  - Other popular currencies include GBP, SEK, JPY, CAD, AUD
- Ratings: Range from AAA to BBB
- The tenor of benchmark-sized green bonds that have been issued range from 18 months to 10 years
- Privately-placed green bonds are more diverse in currency and tenor

Who invests in green bonds?

- Issuing a green bond allows an issuer to taut its green credentials, raise capital and also to diversify its investor base
- More and more investors are focused on environmental, social and governance goals
- The UN articulated Principles for Responsible Investing (PRI)
  - Over 1000 investors have signed on to the PRI, representing over $30 billion in AUM
- Investor Type
  - Asset Managers
  - Pension Funds
  - Insurance Companies
  - Bank/Corporate Treasuries
  - Ultra High/High Net Worth Individuals

Pricing and Trading of Green Bonds

- **Pricing**: in line with issuer’s outstanding senior bond curves
  - Potentially greater pricing leverage due to more investor participation and diversification
- **Trading**: *pari-passu* with regular bonds and as such trade consistent. Buy and hold nature of the investor base can create technical advantages for holders
- **Liquidity**: consistent with similar sized senior unsecured tranches from the borrower

Green Bond Principles

Promoting disclosure & transparency

- As the market has grown and become more diverse, it has become more important to be able to enhance disclosure and transparency
- Investors have been calling for more detailed and more transparent disclosures from issuers regarding their sustainability efforts

Green Bond Principles

- A white paper co-authored by BAML and Citi, the Framework for Green Bonds, formed the basis for the Green Bond Principles
- In January 2014, the Green Bond Principles were agreed in order to promote transparency
- The Principles are not intended to be prescriptive, but rather to be viewed as voluntary best practices intended to provide some guidance for issuers and investors relating to
  - Use of proceeds
  - Project evaluation/selection
  - Management of the proceeds
  - Reporting

Use of Proceeds

- The principal distinguishing factor with a green bond will be the issuer’s intended use of the offering proceeds, therefore, substantial attention is focused on its disclosure
  - Potential eligible categories of investments include:
    - Renewable energy
    - Energy efficiency
    - Sustainable waste management and land use
    - Clean water and water treatment
    - Biodiversity conservation
    - Clean transportation
  - For some specific sub-categories, the Appendix provides resources from environmental experts

Selection Process

- Investors will want to understand how the issuer will approach project selection and how it will measure or assess the impact of projects
  - A framework for choosing projects may be documented or articulated by the issuer as part of its general sustainability initiatives
  - Some issuers may publish their framework on their website
  - Some issuers may obtain a second-party opinion on the framework or the specific uses of proceeds

Tracking Proceeds

- Issuers have adopted varying practices to track the actual use of proceeds
- The Principles suggest that
  - The issuer clearly disclose the process for tracking the proceeds
    - To this end, proceeds can be ear-marked or even moved to a sub-portfolio
    - For added assurance, the issuer can have the tracked proceeds verified by an independent third party such as the issuer's auditors
      - "Attestation" or "verification" usually will require issuer to enter into an engagement letter with the auditors pursuant to which the issuer and auditors will agree on the scope of the work, the work product (attestation letter or other), and how that information can be used or shared with third parties
      - The attestation process is distinct from and unrelated to the traditional comfort letter process
      - Auditors may be concerned about the description of their role in the prospectus and any reliance by third parties on their attestation
      - The attestation would not be "expertized" information

Reporting Process

- Investors will seek out periodic reports regarding the issuer’s progress in deploying the proceeds
- The Principles recommend
  - Annual reporting on which projects received proceeds from the Green Bond
  - Where feasible, reporting could include use of quantitative or qualitative performance indicators to measure the impact of specific projects

Second-party Opinions

- Some issuers have engaged outside parties, such as Vigeo (an ESG rating agency) or DNV or CICERO, to write an opinion about the issuer's "framework"
- Likely that there will be other entrants looking to take part in the market in this way

Evolution of Principles

- A governance process is in place which allows various stakeholders to provide their input on the Principles
- ICMA has been named as third-party Secretariat to facilitate the exchange of information

What’s next

- Indices based on Green Bonds, such as the Solactive index created in partnership with the Climate Bonds Initiative
- Structured securities linked to these indices
- Asset-backed Green Bonds
- Green Project Bonds
- Outside of the Green Bond market, more “impact investments” that align investor’s interest in furthering certain social or sustainability missions
  - Women’s Bonds
  - Vaccination Bonds
  - Social Impact Investments