Social Impact Investing and Green Bonds

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Aligning Investment Objectives and Social Objectives
Aligning investment objectives

- Investors have become more focused on aligning their investment objectives with helping to achieve a positive social mission
- In part, the evolution of “corporate” forms has facilitated this
- Contractual arrangements also may serve to align an investor’s interest in having the enterprise meet a particular mission
Use of equity instruments

• Use of traditional equity instruments (common and preferred stock) to further mission
• Can be established by founders at time of formation or required by investors
• Rights, preferences privileges
  • Separate class of stock for “mission-aligned” investors and founders whose consent
  • Expansion of protective provisions to include mission with business purpose
  • Either class vote for sale or redemption right
  • Board representation
  • Waterfall Provisions/liquidation preferences
  • Redemption trigger for failure to adhere to mission; can also add contractual remedy (take control of board) if unable to honor redemption
Use of debt instruments

• Affirmative and negative covenants regarding mission
• Default if mission violation
  • Alternative use of higher interest rate in event of mission “creep”
• Prepayment requirement for mission deviation (alternative to default to avoid cross-default with other debt instruments)
• Contractual remedies for failure to pre-pay, including take-over of board/control
• Issues with who determines mission default or “creep”
  • Board representation/approval
  • Can establish special committee for revision of mission (CSR committee) but approach may end up marginalizing mission in comparison with operations
Social Impact Bonds
What is a Social Impact Bond (SIB)?

- A Social Impact Bond is a multi-party, pay-for-performance contract that pays investors financial returns based on impact created by a nonprofit organization
  - Government or private entity contracts to pay for social outcomes that save money or create value
  - Investors fund a nonprofit organization to produce the social outcomes
  - If the social outcomes are achieved, the government or private entity pays investors back their principal investment plus financial returns

- A Development Impact Bond (DIB) is a SIB in the developing world.
Current Social Impact Bond Model

Pay for Success Financing Tool

**INVESTORS**
Invest Capital in a Nonprofit Org

**NONPROFIT ORGS**
Implement Services & Report Impact

**PAYERS**
Rpay Investors Based on Nonprofit Orgs Impact

Intermediaries
Structure Deal & Raise Capital

Independent Assessors Evaluate Impact
Social Impact Bond Example

2013 New York City Recidivism Deal

**INVESTOR**
Goldman Sachs
Invests $9.6M

**NONPROFIT ORG**
Recidivism Reduced by +/-10%

**PAYER**
City of New York Repays Principal + Return or Bloomberg Philanthropy Guarantees Principal @ 75%

Intermediaries
Structure Deal & Raise Capital

Independent Assessors Evaluate Impact
Social Impact Bonds have travelled from concept to execution faster than any other social innovation in recent history.*

*SIB Infographic, Rockefeller Foundation, October 2013
# SIB Participant Benefits

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| Investor                         | • Opportunity to invest in the nonprofit sector with the potential to earn both social and financial returns  
                              | • Improved impact data                                                   |
| Nonprofit Organization/Service Provider | • Access to new capital sources  
                              | • Reduce reliance on traditional philanthropy  
                              | • Meritocracy – money follows impact  
                              | • Streamlined impact reporting  
                              | • Freedom from overhead constraints                                    |
| Payer                            | • Pay for performance; deferred payment  
                              | • Higher impact per dollar donated  
                              | • Government spending reform  
                              | • Improved impact data  
                              | • Catalyze new money into the sector  
                              | • Risk-sharing                                                           |
| Guarantor                        | • Pay for performance  
                              | • Catalyze new money into the sector                                     |
| Intermediary                     | • New business opportunity                                                |
## SIB Variations

| Cost Saving vs. Value Creation | Originally, SIBs were applied in cases where the intervention saved the government money and the savings was shared with investors in the form of a financial return. For example, reducing recidivism saves the state money and that savings is shared with investors in the form of a financial return.  
• New applications are being designed where the interventions create value. For example, investing in girls education in the developing world creates value (intellectual capital, future earnings/taxes, etc.) and that value is shared with investors in the form of a financial return. |
| Risk Tolerance | SIBs have various risk sharing structures ranging some of which include guarantors and others that do not. |
| Private Payer vs. Government Payer | Originally, SIBs were applied in cases where the government was the Payer; however, private payers are now emerging as important players, especially in the developing world. For example, Coca Cola is noted as a Payer in a SIB under development in Mozambique for malaria. |
Current SIB Structure

Social Impact Bond ≠ Bond

Limitations
- Private contracts
- Lack of standardization
- Limited accessibility
- Limited liquidity
- Lack of transparency
- Inconsistent reporting
- Lack of market data
New "Impact Security" Model

• A growing number of results-based financing instruments are emerging in the social sector

• If structured appropriately, results-based financing instruments may be considered debt securities ("Impact Securities")

• Impact Securities issued by a government entity and by nonprofit organizations are exempt from SEC registration requirements
  ✓ Nonprofit (501(c)(3)) exemption – Securities Act Section 3(a)(4) exemption
  ✓ Government or municipality exemption – Securities Act Section 3 exemption

• An over-the-counter or interdealer trading market may develop to trade Impact Securities, like the market for muni securities

• Alternatively, an organized market can be established to facilitate trading in Impact Securities
Impact Security Model

INVESTORS
Invest Capital in a Nonprofit Org

PAYERS/DONORS
Repay Investors Based on Nonprofit Orgs Impact

IMPACT SECURITY
ISSUER
501c3 or Government

NONPROFIT ORGS
Implement Services & Report Impact

Investment
Donation
Impact Security
Payment of principal, returns and/or bonus based on impact
New "Impact Security" Model

- A government entity or a 501(c)(3) organization (foundation or nonprofit organization) ("Issuer") serves as a conduit connecting investors, foundations/corporations/individuals ("Donors") and social initiatives in need of capital
- Issuer is self funded and/or receives funding from various sources including foundations, corporations, individuals and government in the form of donations or taxes
- Issuer issues and sells debt instruments to investors in public offering
- Issuer uses offering proceeds to fund specific social initiatives performed by 501c3 nonprofit organizations
- Return to investors contingent on social initiative achieving specified impact results
  - If specified impact results achieved, Issuer pays (i) return to investors, and (ii) “bonus” to successful social initiative (optional feature to align incentives)
  - If specified impact results are not achieved, Issuer does not pay returns or bonus

Restructure the Social Impact Bond model to expand application as well as enable standardization and trading.
New "Impact Security” Model

• By structuring as a “security,” a number of benefits can be achieved:
  • Investors are familiar with offerings of securities
    • Documentation is familiar: a potential investor will receive an offering document and will not be required to review/execute an operating agreement or partnership agreement
    • A security can be more easily held in a brokerage account
  • A security is more readily transferred
    • Transfers would not require assignment of LLC or partnership interests
    • A security may be “traded” on an exchange or through dealers
  • A security may be more readily valued
Securities exemption

- Section 3(a)(4) of the Securities Act provides an exemption from the registration requirements of Section 5 of the Securities Act for securities issued by an entity organized and operated exclusively for charitable purposes and not for pecuniary profit.
- Entity availing itself of, or claiming, the exemption is required to show that it is available.
- “Exclusively for charitable purposes and not for pecuniary profit”
  - A single substantial for-profit purpose will render the exemption unavailable.
  - The entity claiming the exemption must ensure that no part of the entity’s net earnings (if any) will inure to the benefit of a stockholder, member or individual.
Securities exemption

• An entity’s purpose can be established through its organizational documents, including its charter and bylaws
• Charter and bylaws should expressly limit the entity’s activities and limit the entity’s purposes solely to advancing its charitable purposes
• Any descriptions prepared by the entity of its operations should clearly state the entity’s charitable purpose
• Courts and regulators have looked at other “extraneous” evidence of the entity’s purpose. As a result, careful records should be kept by the entity relating to its activities
Securities exemption

• Many non-profits choose to obtain a no-action letter from the SEC confirming that the SEC Staff will not take enforcement action if the non-profit issuer issues and offers securities publicly without registration in reliance on the Section 3(a)(4) exemption
  – Philanthropy Protection Act amended the Section 3(a)(4) exemption to make it broader and provide an exemption for pooled non-profit or charitable vehicles that are excluded from the definition of an “investment company” under the Investment Company Act of 1940 under Section 3(c)(10)(B)
  – In the example, with the “pooled” non-profit, one should also consider the investment company issues
• State securities laws also provide an exemption from registration for “any security issued by any person organized and operated not for private property but exclusively for religious, educational, benevolent, charitable, fraternal, social, athletic, or reformatory purposes”
• State law exemption is broader in scope that the federal securities law exemption
Building a Successful Market

Expand Beyond Government

Establish Standardized Financial Instrument

Increase Transparency
SIB Principles Goals

- Standardization
- Transparency
- Disclosure
- Foster integrity
- Promote participation
A Case Study: 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 would 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 – according to ICMA data, approx $35 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