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ALERT MEMORANDUM

Social Bonds in Response to the COVID-19 Crisis: a Guide for Issuers

14 April 2020

The COVID-19 crisis has had severe economic implications across the world to date and the situation continues to evolve rapidly. Sovereigns, supranational bodies and corporates may be required to look for innovative ways to combat the situation and alleviate its effects, as well as restoring balance sheets and budgets. One such solution gaining traction in the market is the use of social bonds. This memorandum provides an overview of these instruments, sets out a summary of the market and discusses the reasons issuers may consider raising financing using social bonds in the current context.

If you have any questions concerning this memorandum, please reach out to your regular firm contacts, the attorneys listed to the right or our COVID-19 task force by clicking here. For more information on our firm's resources relating to COVID-19, please consult our COVID-19 Resource Center.

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What are Social Bonds?

In essence, social bonds are debt capital markets instruments where the proceeds are applied for 'social' purposes or outcomes. They are similar in concept to 'green bonds' (where the proceeds are applied towards climate and environmental purposes). These outcomes might include the provision of basic infrastructure, affordable housing, food security, healthcare or other essential services.

However, social bonds have also employed more complex structures. For instance, they have been used as non-recourse debt, such as project financing (i.e., to fund projects with a social purpose). In this case, the investors would only have recourse to the project, and not to the issuer or parent entities. Alternatively, a social bond may be structured such that creditors only have recourse to the cash flows associated with the social purpose. These are also known as 'social revenue bonds.'

Recognising market appetite, the International Capital Market Association ("**ICMA**") has published voluntary guidelines for issuing social bonds known as the 'Social Bond Principles' (available here).[1]

[1] See https://www.icmagroup.org/green-social-and-sustainability-bonds/social-bond-principles-sbp/.

These guidelines are intended to provide a degree of standardisation and encourage issuers to adhere to principles for reporting and transparency to ensure objectives are being achieved through the life of the instrument. In return, issuers can benefit from increased investor confidence and more consistent valuations and pricing.[2]

This memorandum is focused on social bonds that follow the ICMA guidelines, as the most recognised form in the market currently. Issuers which market their debt instruments as contributing either in full or in part to a social cause without fully subscribing to the ICMA principles may run the risk of negative media attention. There has been some controversy[3] in China recently on this topic, where corporate issuers have accessed the capital markets on a fast track regulatory process for "virus prevention and control bonds" but only applied a relatively small proportion of the proceeds towards expenditures relating to the COVID-19 crisis.

The social bond market is growing rapidly, as the instruments become more familiar and issuers ascribe a greater priority to environmental, social and governance ("**ESG**") matters. According to Moody's Investor Services, green, social and sustainability bonds accounted for 4.5% of total global bond issuance in 2019, up from 3% in 2018. Social-focused bond issuances are forecast to total $25 billion in 2020.

Why Issue a Social Bond?

There are two primary reasons to issue social bonds. First, a social bond can convey a powerful message. Issuing a bond with a defined social purpose demonstrates that the issuer considers a particular problem a priority. It demarcates a certain amount of funding for a purpose, and allows the issuer to present it as a separate, non-fungible item on the balance sheet or budget. It sends a clear message that a specified amount of funding is committed to the defined purpose, that this funding stream will not be cut in future, and that the funds will only be used for the defined purpose and not applied elsewhere.

Second, it allows the issuer to appeal to a broader range of investors, including those who are focused on ESG considerations. This group of investors has grown rapidly over recent years and are now a significant source of capital across the world: in 2018, signatories to the UN-sponsored "Principles for Responsible Business" had $80 trillion in assets under management. Having access to a broader range of potential investors can bring advantages in terms of pricing and liquidity.

Social Bonds in response to the COVID-19 Crisis

The COVID-19 crisis has presented significant challenges for the global economy, and society more generally. Novel ways to access capital in order to, among other things, alleviate supply chain strains, provide healthcare or public health solutions and research new technologies and medicines are therefore a top priority. Social bonds may assist with this, as the International Finance Corporation ("**IFC**") has illustrated in its document describing social bond use of proceeds case studies.[4] In response to this renewed interest, ICMA have published a Q&A document[5] which addresses topics related to social bonds and COVID-19.

Two major issuances have occurred since the crisis began. On 20 March 2020, the IFC issued $1 billion of notes with a three year maturity designated as social bonds to support the private sector and jobs in developing countries affected by the COVID-19 outbreak. On 27 March 2020, the African Development Bank ("**AfDB**") raised $3 billion of notes with a three year maturity under its social bond

[2] It should be noted that social bonds differ from so-called 'social impact bonds.' The latter is typically structured as a contract with a public body whereby the payment is contingent on certain outcomes. As an example, the first ever social impact bond in 2010 was used to prevent reoffending in a prison in the United Kingdom. Investors funded intervention strategies aimed at preventing reoffending and were repaid from the savings created for the UK Ministry of Justice. In contrast, the term 'social bond' refers to a fixed-income instrument, and as such attracts a different investor base.

[3] See https://in.reuters.com/article/china-health-virusbond/chinese-companies-tap-virus-bonds-to-raise-billions-quickly-idINKBN2072FE.

[4] See https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/SB-COVID-Case-Study-Final-30Mar2020-310320.pdf.

[5] See https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/Social-Bonds-Covid-QA310320.pdf.

framework, described further here.[6] As the crisis is still unfolding, it is likely that more supranational organisations, sovereigns and corporate issuers will follow suit in the coming months.

Supranational Issuers

Many supranational organisations (such as the IFC and AfDB) already have social bond frameworks in place, and are able to quickly issue new notes in response to the crisis under existing programs using these frameworks. These funds can be applied to purposes that fall within such organisations' mandates. Taking the AfDB as an example, their social bond is intended to alleviate the economic and social impact of COVID-19 in Africa, which aligns directly with their regional development objectives.

Sovereign Issuers

The sovereign social bond market is nascent, but presents an opportunity for governments to apply its external debt towards public policy goals. In January 2020, Ecuador issued the world's first sovereign social bond[7] to boost a government housing program. Sovereigns may consider issuing social bonds to mitigate the impact of COVID-19 on their national economies or public services. These purposes might include funding the health service, funding production of vital equipment such as ventilators or funding research into vaccine research or other drug treatments. Alternatively, the purpose might be less directly related and address issues indirectly caused by the crisis. For instance, the funds could be applied towards social security programs, housing, support for small businesses or employees, or other government policy objectives.

Aside from achieving policy goals, sovereigns that issue social bonds in response to the COVID-19 crisis could send a clear message to their people that the government considers such an issue a priority. Further, social bonds could diversify a sovereign issuer's creditor profile, improve the sustainability of its wider debt portfolio and allow enhanced access to supranational guarantee support.

Corporate Issuers

Corporates may also consider issuing social bonds in response to the COVID-19 crisis, for the reasons set out above. Companies raising sustainable financing at a time of unprecedented global catastrophe would demonstrate their commitment to ESG issues and the community in which they operate. In January 2020, India's largest asset financing company Shriram Transport Company issued a $500 million ICMA-compliant Reg S/144A social bond[8] to encourage

Questions for Potential Social Bond Issuers to Consider:

- What is the 'social' project the financing is to be applied towards and how does it compare against ICMA guidelines?
- Who is contemplated to benefit from the financing?
- Will the bond refinance existing indebtedness or relate to a new project?
- If multiple issuances are contemplated in the future, would a social bond framework or published statement of intent be helpful?
- How will social and environmental risks associated with the project be managed?
- What processes can be put in place to monitor the use of proceeds and ensure transparency to investors?
- What level of reporting is feasible during the life of the bond?
- What level of external review can be undertaken? Issuers may consider obtaining an opinion, verification or certification from an independent party to demonstrate alignment of their social bond with the recognised frameworks or standards.
- What are the commercial terms being sought, to whom will the instrument be marketed and what are the regulatory considerations associated with the issuance?

[6] See https://www.afdb.org/en/news-and-events/press-releases/african-development-bank-launches-record-breaking-3-billion-fight-covid-19-social-bond-34982.

[7] See https://www.iadb.org/en/news/ecuador-issues-worlds-first-sovereign-social-bond-support-idb-guarantee.

[8] See https://esg.theasset.com/ESG/39521/shriram-transport-prices-indias-first-public-social-bond

employment through SME financing. The issuance was four times oversubscribed, demonstrating significant international investor interest.

Conclusion

The full impact of the COVID-19 crisis is not yet clear, but innovative solutions will be of paramount importance to global recovery. Whilst the social bond market is in its infancy, investors and creditors were, prior to the onset of the pandemic, increasingly prioritising ESG matters in their investment decisions. This, in combination with global demand arising from recent events, could drive the market for such instruments to expand considerably.

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