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Understanding Social Bonds

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Introduction

In 2021, the regulatory body for securities offerings in Nigeria, the Securities and Exchange Commission, Nigeria ("**SEC**") issued the New Rule on Social Bonds (the "**Social Bond Rules**") to regulate the issuance of social bonds in Nigeria. Social bonds, as an alternative to conventional bonds, are a new way to finance social services and development projects. Broadly speaking, because they seek to create positive social impact, they are considered as useful instruments stacked with opportunities not just for their target communities, but also for both issuers and investors. This article examines the nature of social bonds, the key provisions of the Social Bond Rules, and the opportunities and challenges connected with the issuance of social bonds.

Understanding Social Bonds

Social bonds could significantly increase access to capital for projects that contribute to socio-economic advancement and empowerment, affordable basic infrastructure, affordable housing, access to essential services, employment generation, food security and sustainable food systems. The aforementioned areas have been identified as categories of "social projects" by the International Capital Market Association's[2] Social Bond Principles, June 2021 (with June 2022 Appendix) (the "**ICMA Social Bond Principles**") and the Social Bond Rules.

According to the Social Bond Rules, a social bond is a debt instrument whose proceeds would be exclusively applied to finance or refinance eligible projects with clear and identifiable social objective(s) and which are dedicated to a target population. A project is eligible as a "social project" if it is directly aimed at addressing or mitigating a specific social issue and/or seeks to achieve positive social outcomes, whether or not exclusively, for a target population.[3] On the other hand, the ICMA Social Bond Principles recognise that social projects may especially, but not exclusively, impact a target population.

Key Provisions of the Social Bond Rules

Specifically, the projects that are "eligible" under the Social Bond Rules mirror the categories of social projects under the ICMA Social Bond Principles, but with one difference. The Social Bond Rules leave

[1] Authors: Ayodele Ashiata Kadiri and Victor Ayo-Odewale. Many thanks to Iyinoluwa Ajayi for her contributions to this piece.

[2] The International Capital Market Association is a not-for-profit association of private and public sector issuers, banks and securities dealers, asset and fund managers, insurance companies, law firms, capital market infrastructure providers and central banks working together to promote "*the development of the international capital and securities markets, pioneering the rules, principles and recommendations which have laid the foundations for their successful operation*". See https://www.icmagroup.org/About-ICMA/.

[3] Rule 1.

room for additional eligible projects to be approved by the SEC from time to time.[4] The target population to which the project(s) must be dedicated are people living below the poverty line, excluded and/or marginalized populations, vulnerable groups, people with disabilities, migrants and/or displaced persons and undereducated populations. Others are underserved populations who lack access to essential goods and services, unemployed persons, and other target populations as may be included in the Social Bond Principles as updated from time to time.[5] The ICMA Social Bond Principles have a more extensive list which includes (a) women and/or sexual and gender minorities, (b) aging populations and vulnerable youth, and (c) other groups that have become vulnerable as a result of natural disasters.

As conditions for the approval of social bonds, the Social Bond Rules require an issuer of social bonds to file, in addition to the general registration requirements for debt issuances as stated in the SEC Rules, 2013 (as amended), the following: (a) a letter committing to invest the net proceeds of the bond in projects that qualify as social project(s) or assets in line with the Social Bond Rules, (b) a feasibility report stating the measurable benefits of the proposed social project or assets and their expected impact, (c) a prospectus to disclose the social objectives of the project, project selection criteria, decision-making procedures, social and environmental benefits, risks associated with the projects, and the use and management of the proceeds, (d) an independent assessment or certification issued by a professional certification authority approved or recognized by the SEC, and (e) any other documents the SEC may require.[6]

The Social Bond Rules also provide for the utilization and management of issue proceeds.[7] The net proceeds from the issue are to be: (i) tracked as contained in the approved internal policy of the issuer, which would have been disclosed in the offer documents; (ii) domiciled with a custodian in an escrow account specifically opened for the net proceeds; and (iii) utilized solely for the purpose(s) stated in the offer documents. The issuer has to disburse the proceeds towards the particular social project within the timeframe prescribed in the prospectus for the bond issuance. Proceeds which are unallocated are to be invested by the trustees in money market instruments with investment grade rating that may include projects that are consistent with the delivery of positive social outcomes.

Additionally, under the Social Bond Rules, (a) for as long as the social bonds are outstanding, an issuer shall provide to the SEC and any exchange where the social bonds are listed an annual social bond report containing the list of the projects and assets to which the proceeds have been allocated;[8] (b) if a proportion of the issue proceeds shall be applied towards the refinancing of existing social assets, the issuer must make full and clear disclosure of the details of the assets/portfolio/projects to be refinanced in the offer documents;[9] and (c) the issuer shall appoint an external review provider to confirm the alignment of the proposed bonds with all components of the social bond principles.[10]

Opportunities Specific to Social Bonds

Social bonds present investors with the opportunity to fund projects with significant social impact. Organizations with a focus on improving livelihood and financing humanitarian services can issue social bonds to implement their goals and objectives.[11] These organizations will typically include

[4] Rule 2(a).
[5] Rule 2(b).
[6] Rule 3.
[7] Rule 4.
[8] Rule 5.
[9] Rule 6.
[10] Rule 7.
[11] A major advantage social bonds have over conventional bonds is that they enable issuers to be seen to address some of the topical and most critical issues in the society. This advantage is generally a core feature of sustainability bonds (which includes social bonds and green bonds). Through social bonds, issuers can support low-income communities, women entrepreneurs, and small businesses in emerging markets.

governmental bodies (at various levels), companies, foundations and trusts, supranational organizations and development finance institutions; and foreign issuers are certainly welcome.[12] As a growing number of investors are integrating environmental, social and governance ("**ESG**") principles into their investment strategies, investment in social bonds present investors with opportunities to improve their ESG credentials.

Investments in social bonds also promote greater transparency in terms of use of funds. In addition to the requirement to hold the proceeds of the social bonds in escrow with a custodian, the Social Bond Rules also extensively provides for the use of proceeds from social bonds. The risk of diversion of the funds to other purposes is also greatly reduced as investors can 'follow' their investments during the life of the project.

Further, social bonds are less likely to suffer the risk of undersubscription by investors. First, social bonds increase the diversity in available instruments in the Nigerian capital markets. Second, the social impact value nature of social bonds is likely to propel investors to purchase the bonds, thereby reducing the risk of having underwriters buying unsold bonds. For instance, social bonds issuances in the wake of COVID-19 pandemic[13] were reported to have jumped eight-fold from the previous year.[14]

Why Social Bonds are yet to Achieve Popularity

Although social bond issuance has been on the rise in recent times, it has, however, remained limited both in terms of volumes and active issuers. This can be attributed to insufficient, or lack of, understanding of the subject, mechanics and technical aspects of social bonds. This includes the

[12] In data presented by Climate Bond Initiative in 2020, it was reported that 47% of social bonds are issued by governments and government-backed entities and about 13% are issued by supranational organizations. About 37% are issued by corporations. See https://www.pionline.com/investing/european-interest-social-bonds-growing. The World Bank Group, through its Sustainable Development Bonds, supports the financing of a combination of green and social, which include sustainable development, projects, programmes, and activities in member countries, with each project designed to achieving both positive social and environmental impacts and outcomes in line with (a) the Group's twin goals of eliminating extreme poverty and promoting shared prosperity and (b) the Sustainable Development Goals. See https://treasury.worldbank.org/en/about/unit/treasury/ibrd/ibrd-sustainable-development-bonds

[13] The COVID-19 pandemic threatened the well-being of the world's population and severely impacted vulnerable groups (who are the envisaged target population under the Social Bond Rules and the ICMA Social Bond Principles).

[14] It was reported that as at October 2020, the issuance of social bonds worldwide had surged to $85 billion, compared to $10.6 billion in the same period in 2019. See www.reuters.com/article/us-social-bonds-data-idINKBN274256. In 2021, social bond issuance significantly increased and nearly reached $200 billion. See https://www.businessinsider.com/social-bonds-growing-issuers-investors-still-learning-merits-2022-5?r=US&IR=T.

challenge with grasping defining outcomes, pricing outcomes, and financial modelling.[15] This challenge can be addressed by employing the services of specialist advisors.

Second, the definitions of "social projects" and "eligible projects" under the Social Bond Rules are open-ended and give room for the inclusion of any project which may have social nomenclature but with no actual social effect. For example, some social issues may have controversial or political connotations, and this may discourage potential investors with divergent views on these issues. Some examples include issues relating to migration and/or displacement, and women and/or sexual and gender minorities.

Third, there is at the present time little to no data on the performance of issued social bonds as it relates to financial returns. This may affect investors' confidence in investing in social bonds as they may be apprehensive of not recouping their investments and profits in due time without the issuers' default. The concern here is stronger where the issuer is a corporate body rather than the government. Closely related to the aforementioned concern is that the primary goal of social bond is to finance socially sound and sustainable projects and not necessarily to generate profits on investments. The returns generated from the projects are used in making repayments to the investors. However, it is possible that some projects may be incapable of generating returns to be used in repaying investors, if they are not profit-oriented.

Conclusion

Social bonds provide more options for investors looking to fund impactful projects. The SEC's attempt to boost investor confidence in social bonds by issuing the Social Bond Rules is commendable. Investors should take advantage of the opportunity to contribute socio-economic development whilst committed to receiving their principal and returns on investments. Even though there was no record of a social bond issuance in Nigeria as at the time this piece was written,[16] the Nigerian government at various levels and corporate bodies can leverage social bonds in creating impact in the society and solving some of the most critical social problems and issues amongst the most vulnerable population.

[15] For investors such as pension funds, the challenges with investing in social bonds have been liquidity risk, scalability and the lack of a framework which can aid investors in measuring the impact of their investments and communicating them to plan participants. See n 12 (*supra*).

[16] The case is different for the African continent as a whole. For instance, in April 2022, the African Development Bank ("**AfDB**") launched an AUD 155 million 10.5-year Kangaroo social bond, due in October 2032, marking its first social bond transaction of the year. This issuance seeks to finance socio-economic development in AfDB's regional member countries, considering the worsening the food situation on the continent and the rise in energy prices.

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