

ISSUE BRIEF



# CATALYTIC FIRST-LOSS CAPITAL

OCTOBER 2013



## **ABOUT THE GLOBAL IMPACT INVESTING NETWORK**

The Global Impact Investing Network (GIIN®) is a nonprofit organization dedicated to increasing the scale and effectiveness of impact investing. The GIIN builds critical infrastructure and supports activities, education, and research that help accelerate the development of a coherent impact investing industry. For more information, see [www.thegiin.org](http://www.thegiin.org).

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# Executive Summary

In the nascent but growing impact investment market, some investment opportunities<sup>1</sup> that have strong potential for social or environmental impact are perceived as having high financial risk. Catalytic credit enhancement tools, such as first-loss capital, can encourage the flow of capital to these opportunities by improving their risk-return profiles and, thus, incenting others to invest. Providers of such credit enhancement have several motivations, including magnifying positive impact and fostering market development. At the same time, there are legitimate concerns related to market distortion and moral hazard behavior. This is where careful expectation setting and deal structuring is paramount, and lessons on both fronts can be learned from real-world experiences.

<sup>1</sup> "Opportunities" is an umbrella term for any type of entity set up to receive investment capital, e.g. funds, products, and firms.

# Introduction

## CREDIT ENHANCEMENT

Credit enhancement is commonly used in traditional financial markets to improve the credit worthiness of a particular investment opportunity. It plays an important role in conventional investing, from bank letters of credit facilitating trade financing to government loan guarantees spurring business growth. There are many examples. In the US, the Small Business Administration (SBA) runs a program that guarantees up to 85% of commercial loans made to small businesses.<sup>2</sup> Elsewhere, government sponsored enterprises, such as Fannie Mae and Freddie Mac aim to enhance the availability of, and reduce the cost of, home ownership for low-, moderate- and middle-income Americans, by providing credit enhancement to reduce the risk of capital losses to investors. Together, Fannie Mae and Freddie Mac purchase or guarantee between 40 and 60 percent of all mortgages originated in the United States annually.<sup>3</sup>

**IMPACT INVESTMENTS** are investments made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return. They can be made in both emerging and developed markets, and target a range of returns from below market to market rate, depending upon the circumstances.

In the nascent but growing impact investment market, some investment opportunities that have strong potential for social or environmental impact are perceived as having high financial risk. While some are seen as not producing sufficient financial returns for their level of risk, others suffer from a lack of information or track record given the novelty of either the market or a particular type of investment opportunity. Credit enhancement can encourage the flow of capital to these investment opportunities by improving their risk-return profiles and, thus, incenting more investors to invest.

While there is much discussion about the role of credit enhancement in the impact investment market, it remains underutilized. There is a lack of information on performance, as well as clarity on the benefits—especially to those providing protection (see Figure 1)—due to limited data on deals and results. The paucity of precedent or comparables also causes uncertainty which, in turn, leads to high search and transaction costs. More information and clarity is particularly important as more investors across the risk-return spectrum explore opportunities to engage with the impact investment market.

## CATALYTIC FIRST-LOSS CAPITAL

There are a broad range of tools that can be used to provide credit enhancement. These include letters of credit, first-loss capital, over-collateralization, insurance, and reserve accounts. This issue brief will focus on one particular credit enhancement tool, which will be referred to as catalytic first-loss capital (CFLC), which is defined in detail on page 5. (Subsequent research briefs may focus on other credit enhancement tools.) CFLC is a tool that has gained prominence of late in the impact

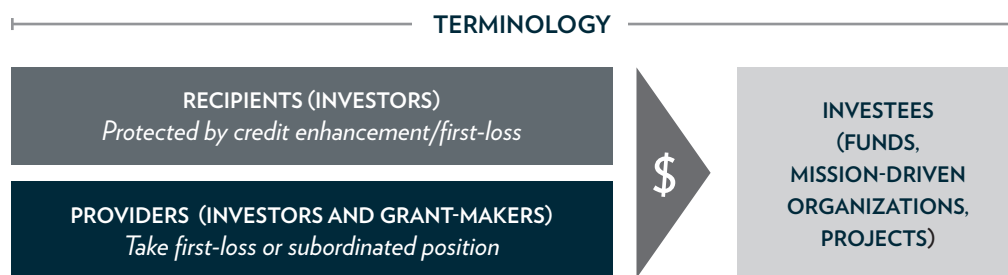
<sup>2</sup> This is known as the SBA 7(a) loan guarantee program. As of Sep-2011, the SBA had guaranteed 78% of principal in 53,000 loans to small businesses across the US, totaling nearly USD 20 billion in loans. Sources: SBA, General Small Business Loans: 7(a), <<http://www.sba.gov/content/7a-loan-amounts-fees-interest-rates>> and National Association of Government Guaranteed Lenders, <[http://www.naggl.org/AM/Template.cfm?Section=SBA\\_Statistics](http://www.naggl.org/AM/Template.cfm?Section=SBA_Statistics)>.

<sup>3</sup> Source: Investopedia, <<http://www.investopedia.com/terms/f/fanniema.asp>>.

investing innovation discourse. In theory, it is a particularly powerful method of moderating risk and, thus, of catalyzing more risk-averse sources of capital. In practice, a number of recent transactions have incorporated, and benefited from, CFLC in their capital structures. Impact investors are experimenting with CFLC in innovative ways to reduce risk, advance social and environmental objectives using commercial capital at scale, and stimulate investment activity in new markets.

*“Impact investing at the BoP (Base of the Pyramid) creates new opportunities to leverage scarce ODA (Overseas Development Assistance) and philanthropic resources. By funding first-loss tranches... they can serve as a catalyst for bringing additional private capital to the table in pursuit of development outcomes.”<sup>4</sup>*

**Figure 1: Providers of protection and Recipients of protection**



It is worth acknowledging that the term “first-loss capital” does carry negative connotations for some investors. In some circles it is seen as “dumb money,” i.e., money which is provided solely to improve a transaction’s financial profile for other investors, without any discernible benefits for the Provider. There are also moral hazard concerns: *By providing first-loss am I encouraging potentially perverse risk-taking behavior?* Finally, there is a concern around distorting markets, i.e., that such practices can actually work against the objective of building a commercial market.

The terms **‘PROVIDER’** and **‘RECIPIENT’** will be used throughout this report to refer to, respectively, those investors or grant-makers that provide protection for other investors, and those investors who receive protection from other investors, as opposed to an Investee, which is the entity that receives investment.

Such concerns exist largely due to misperceptions and a lack of clarity around both the benefits of CFLC and the structuring mechanisms that drive benefits and prevent potential downsides. CFLC can be a powerful tool to catalyze much greater impact investment and, in doing so, create benefits not only for the Recipient but also for the Provider. In particular the Provider’s mission can benefit from (A) leveraging far greater volumes of capital towards addressing social challenges than they could mobilize on their own in the absence of CFLC, (B) laying the groundwork for sustainable investment flows into markets previously untouched or underserved by formal capital markets, and (C) helping improve the terms at which Investees can access capital.

<sup>4</sup> Maximilian Martin, “Making Impact Investible”, Impact Economy Working Papers, Vol. 4.

This issue brief will seek to address the various information gaps identified above by:

1. Defining CFLC in impact investing;
2. Outlining scenarios suitable for using the tool;
3. Identifying important considerations for Providers and Recipients; and
4. Drawing general lessons from case studies of various transactions that have incorporated CFLC in their capital structures.

It is hoped that this information can be helpful to investors in evaluating and using CFLC in future transactions.

## Defining Catalytic First-Loss Capital

Catalytic first-loss capital (CFLC) is best defined by three identifying features:

- **It identifies the party, i.e., the Provider, that will bear first losses.**  
The amount of loss covered is typically set and agreed upon upfront.
- **It is catalytic.** By improving the Recipient's risk-return profile, CFLC catalyzes the participation of investors that otherwise would not have participated.
- **It is purpose driven.** CFLC aims to channel commercial capital towards the achievement of certain social and/or environmental outcomes. In addition, often—though not always—the purpose can be to demonstrate the commercial viability of investing into a new market.

CFLC is a tool that can be incorporated into a capital structure via a range of instruments (see Table 1). Commonly used CFLC instruments include grants, equity, subordinated debt,<sup>5</sup> and guarantees. It's perhaps useful to reflect for a moment on the above three defining features, which help distinguish CFLC instruments from other instruments used in impact investing. Unlike conventional commercial equity or subordinated debt in transactions without equity—which both take the first loss and therefore reduce risk for other investors—equity or sub-debt provided expressly as CFLC also seeks to achieve specific social and/or environmental goals.<sup>6</sup> Unlike *pari passu*<sup>7</sup> guarantees and general grants for business purposes, which may also reduce risk for other investors and leverage additional capital, grants and guarantees provided expressly as CFLC are distinct because they always take the first loss (up to a pre-specified threshold) in the event of losses.

5 A loan (or security) that ranks below other loans (or securities) with regard to claims on assets or earnings. In the case of default, creditors with subordinated debt wouldn't get paid out until after the senior debtholders were paid in full. Therefore, subordinated debt is more risky than unsubordinated debt." Source: Investopedia, <<http://www.investopedia.com/terms/s/subordinateddebt.asp>>.

6 CFLC Providers may seek risk-adjusted returns or they may be concessionary.

7 A Latin phrase meaning "equal footing." In Finance, *pari passu* refers to situations where two or more parties have equal rights or obligations.

**Table 1: Instruments commonly used to provide CFLC**

INSTRUMENT	DESCRIPTION
EQUITY	By taking the most junior equity position in the overall capital structure, the Provider takes first losses (but perhaps also seeks risk-adjusted returns); this includes common equity in structures that include preferred equity classes
GRANTS	A grant provided for the express purpose of covering a set amount of first-loss
GUARANTEES	A guarantee to cover a set amount of first-loss
SUBORDINATED DEBT	The most junior debt position in a distribution waterfall <sup>8</sup> with various levels of debt seniority (with no equity in the structure) <sup>9</sup>

SOURCE: GIIN

## The Centrality of the CFLC Provider

### WHO ARE THE ‘PROVIDERS’

Providers are the chief protagonists of CFLC: their ability and willingness to offer protection to other investors are the most important factors in driving greater capital flows via such structures. One characteristic of Providers is that they are strongly aligned with the Investee’s social or environmental goals and theory of change. Another is that they are willing to take on greater financial risk in return for driving towards target non-financial objectives. A third is that they may have a deeper knowledge of the target sector or geography and, hence, a better understanding of the risks, than mainstream investors. Given these characteristics, Providers are typically foundations, high-net-worth individuals, governments, and Development Finance Institutions (DFIs); however, any investor with the appropriate motivation and risk appetite can, of course, play this role.

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*“Philanthropy must do what it does best: peel back the first layer of risk, and experiment where other sectors cannot, making development and commercial investment dollars more productive and less risky.”<sup>10</sup>*

**DR. JUDITH RODIN, PRESIDENT, THE ROCKEFELLER FOUNDATION**

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<sup>8</sup> A type of payment scheme in which higher-tiered investors receive payments (interest / principal / dividends) in full first before the next tier receives any payments. Definition adapted from Investopedia: <<http://www.investopedia.com/terms/w/waterfallpayment.asp>>.

<sup>9</sup> Even if there is no equity in the structure, there may be a reserve account.

<sup>10</sup> Dr. Rodin’s keynote address during the G8 Social Impact Investment Forum, held in London on June 6, 2013.



## VALUE PROPOSITION FOR PROVIDERS

There are several ways Providers' goals can be advanced through CFLC.

- 1. Impact acceleration:** By offering CFLC, Providers can typically attract greater amounts of capital towards a targeted impact than they could aggregate by utilizing their own funds alone, thus multiplying the scale of impact many-fold.
- 2. Resource optimization:** By incenting commercial investors to explore a new market, Providers can potentially demonstrate the market's long-term commercial viability, encouraging investors to continue to invest without credit enhancement. This allows Providers to channel their scarce resources towards issues and areas where the market case is not yet proven.
- 3. Better terms for Investees:** By reducing the risk for Recipients, and by fostering greater competition in new financial markets, Providers can enable improved terms—such as lower cost of capital—for end Investees that are working on addressing important social and/or environmental problems.

It's important for Providers to understand that often, when trying to entice someone to wade into uncharted waters, it's valuable to present them with the opportunity to dip their toes first rather than requiring them to plunge right in. CFLC enables this in a very pragmatic way. Of course, it's important to understand situations in which CFLC is going to be required for the long-term—because the risks are too great—and where one can use CFLC over a short period to get more mainstream investors into a given type of investment opportunity, and these two scenarios shall be delineated in the next section.

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## Scenarios Suitable for CFLC

### LEVERAGE-FOR-IMPACT

There are many areas with strong promise for social and/or environmental returns, but where competitive risk-adjusted rates of financial return are not feasible. Typically, there is a limited set of investors—such as foundations and DFIs—who fund projects in these areas. However, sometimes it may be possible to create a more attractive investment opportunity in these areas via the provision of an appropriate amount of CFLC. The benefit of doing so is that a lot more capital may be mobilized towards the pursuit of targeted social and environmental impact. Given that the opportunity is not seen to have any potential of becoming commercially viable in the foreseeable future, continuous and ongoing credit enhancement will be required to maintain the inflow of commercial capital.

## MARKET DEVELOPMENT

There are some markets about which certain sets of investors have far greater knowledge than do others. Such information asymmetries are particularly prevalent in impact investing markets: some investors, such as foundations and governments, often have a good amount of experience in sectors and regions where more risk-averse investors, such as banks or institutional investors, have limited experience. Investors unfamiliar with these markets may believe investment risks to be greater than they actually are, and may thus be unwilling to invest.

Prospective Providers, on the other hand, with their greater experience, may believe these markets to be commercially viable (or at least very close to being so), and that other investors are misperceiving risk. The primary value of CFLC, in these cases, is to draw those investors into the market so that they will gain a firsthand understanding of the financial viability of investing in these sectors and/or geographies. The Provider is counting on this demonstration effect: if the investment performance is sound, it can lead investors to alter their risk-return expectations and to subsequently re-invest (either in the same opportunity or in other opportunities in the same market) with reduced credit enhancement or, potentially, no credit enhancement at all.

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*The Provider is counting on this demonstration effect: if the investment performance is sound, it can lead investors to alter their risk-return expectations and to subsequently re-invest with reduced credit enhancement.*

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In some cases, it may be that the Provider only needs to supply CFLC once in order for this demonstration to take place. In others, the Provider may need to offer protection multiple times, typically reducing protection levels each round as the investment gets closer to being commercial. However, the notable difference with the first scenario—leverage-for-impact—is that in this case the Provider believes the opportunity to be potentially commercially viable in the foreseeable future and that, by catalyzing greater investment, it can bring about this market development.

## Value Proposition for Recipients

The motivations of Recipients for CFLC are generally well understood, and follow naturally from the above discussion. Given that some impact investing opportunities are in nascent markets, or focus on either unfamiliar or unproven business models, traditional investment parameters can be difficult to calculate given a lack of comparables as well as opportunity-specific information. Thus, the perceived or actual risks can be significant deterrents to investment. Consequently, Recipients may gain two primary benefits from participating in a transaction involving CFLC:

- **Meeting investment parameters:** Though they may be motivated by an investment's potential social or environmental impact, Recipients may be subject to specific risk-return bounds, including those imposed by fiduciary constraints. A typical bound, for example, may

be a rule that specifies a maximum acceptable level of risk for a given expected return. In the absence of credit enhancement, certain impact investment opportunities may fall outside these bounds. Indeed, leading impact investors have noted that a lack of appropriate capital across the risk-return spectrum is the top challenge to market growth.<sup>11</sup> By reducing Recipients' potential loss from an investment, CFLC changes the risk-return profile of an opportunity enough to incent and/or enable Recipients to invest. Specific expertise that the Provider may bring to the table—such as knowledge of the market or capabilities around impact measurement—can work to further reduce risk.

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- **Competitive advantage:** By investing with CFLC, Recipients can acquire expertise in, and learn about, a new market, with the comfort of some downside protection. Indeed, often they will have the benefit of first-mover advantage given the untapped nature of many impact investing markets, and they can even consider the incorporation of clauses such as right-of-first-refusal<sup>12</sup> as part of the transaction documents.

## Case Studies

Five case studies are included in this report, each of which uses CFLC in its capital structure and together illustrate the broad range of ways in which credit enhancement can be used in impact investing. They highlight examples in a variety of geographies, sectors, and investment structures. They also illustrate how the tool can be incorporated via a range of instruments and they reflect the diversity of scenarios and Provider benefits outlined earlier in the report. Two of these cases—Community Finance Fund for Social Entrepreneurs (CFFSE) in Australia and Peak II in Tanzania—fall under one scenario: Market Development. Three others—the FreshWorks Fund, Democracy Prep and FlexCAP—fall under the other scenario: Leverage-for-Impact.

<sup>11</sup> Saltuk, Y., Bouri, A., Mudaliar, A., Pease, M., Perspectives on Progress: The Impact Investor Survey, 07-Jan-2013.

<sup>12</sup> From Investopedia: "A contractual right of an entity to be given the opportunity to enter into a business transaction with a person or company before anyone else can... If the entity with the right of first refusal declines to enter into a transaction, the owner of the asset is free to open the bidding up to other interested parties." <<http://www.investopedia.com/terms/r/rightoffirstrefusal.asp>>.

MARKET DEVELOPMENT

LEVERAGE-FOR-IMPACT

	COMMUNITY FINANCE FUND FOR SOCIAL ENTREPRENEURS (CFFSE)	PEAK II	CALIFORNIA FRESHWORKS FUND—TERM DEBT FACILITY	DEMOCRACY PREP CHARTER SCHOOL	FLEXCAP
<b>GEOGRAPHY</b>	Australia	Tanzania	California, U.S.	New York, U.S.	U.S.
<b>IMPACT OBJECTIVE</b>	Access to finance for low-income populations	Equipment finance lending	Healthy food in low-income communities	Affordable charter school real estate	Home ownership for low-income and under-privileged populations
<b>CFLC AMOUNT</b>	USD 4.1 million (AUD 4.5 million)	USD 1.2 million (EUR 1 million)	USD 7.5 million	USD 0.3 million	1 quarter of payment + 5% of outstanding
<b>AMOUNT CATALYZED</b>	USD 5.5 million (AUD 6 million)	USD 3.6 million	USD 125 million	USD 3.3 million	USD 141 million (since 1996)
<b>PROTECTION RATIO<sup>13</sup></b>	37.5% initially (may reduce with additional investors)	25% initially (may reduce with additional investors)	6%	5.8%	A little over 5% (see case study for details)
<b>CFLC INSTRUMENT</b>	Grant	Equity-like (converted from restricted grant)	Grant	Grant	Reserve account + guarantee
<b>YEAR</b>	2011	2012	2011	2008	1997
<b>PROVIDER(S)</b>	Australian Government's Social Enterprise Development and Investment Fund (SEDIF)	Equity for Africa (via the Government of the Netherlands)	The California Endowment, JPMorgan Chase Foundation, U.S. Treasury's CDFI Fund	Civic Builders (via U.S. Dept of Education)	Habitat for Humanity
<b>PROVIDER TYPE(S)</b>	Government	Fund Manager (via government)	Foundations, Government	Nonprofit Organization (via government)	Nonprofit Organization
<b>RECIPIENT(S)</b>	Christian Super	Multiple Investors	JPMorgan, Citibank, Morgan Stanley, Bank of America, Metlife, Charles Schwab	Low Income Investment Fund	Multiple investors
<b>RECIPIENT TYPE(S)</b>	Pension fund	Various—across Investor Types	Banks and insurance company	Community Development Finance Institution	Various—primarily banks, pension funds, insurance companies

<sup>13</sup> Protection ratio defined as:  $\left( \frac{\text{Amount of CFLC protection}}{\text{Total amount of investable capital}} \right) \times 100\%$

## MARKET DEVELOPMENT CASES

In the CFFSE case, both the Provider and the Recipient believed in the commercial viability of the underlying market. But the Recipient is a pension fund—with attendant fiduciary constraints—and so, given the limited track record in the market, the protection was necessary for investment committee approval. Further, both parties hope that, via strong performance, they can demonstrate market viability to other potential investors.

In the Peak II case, the Provider believed in the underlying business model, but sensed investor reluctance since it was the first time something like this was being attempted in Tanzania. One of the Recipients, Lundin Foundation, noted that they were interested in the underlying machinery asset lending model, but that they wanted a safe way to gain access to sector. So, a waterfall structure was created to provide protection to more senior investors, while the Provider invested in the subordinated position. As with CFFSE, if Peak II performs well, protection for existing senior investors will reduce as more investors come in to meet the target fund size.

### COMMUNITY FINANCE FUND FOR SOCIAL ENTREPRENEURS

*Financial services  
for low-income  
populations in Australia*

### PEAK II

*Equipment finance  
lending in Tanzania*

## LEVERAGE-FOR-IMPACT CASES

The California Endowment's goal with the FreshWorks Fund is to increase the availability of healthy food options in areas where there is limited access, particularly low-income communities. Its primary objective is to generate capital leverage rather than demonstrate the opportunity for commercial returns in that market, and one can argue that the leverage that has been achieved—USD 125 million in investment capital for USD 7.5 million in CFLC—has been substantial.

Civic Builders aims to provide affordable charter school real estate, and it has done this by providing protection to more senior investors investing in dozens of schools nationwide. Financing for charter school operator Democracy Prep is one such example. And while market demonstration was not the objective here, the Recipient, Low Income Investment Fund (LIIF, a community development finance institution<sup>14</sup>), gained enough comfort and expertise through the transaction that it now takes subordinated positions to other commercial investors in similar opportunities.

Via FlexCAP, Habitat for Humanity International's (HFHI) goal was to build more homes for low-income families by attracting commercial sources of capital. Since 1997 it has catalyzed more than USD 140 million—a significant amount of capital, more than what HFHI could have channeled itself directly—in commercial debt by providing a little over five percent loss protection on outstanding principal.

### CA FRESHWORKS FUND—TERM DEBT FACILITY

*Healthy food options  
in low-income  
communities in  
California*

### DEMOCRACY PREP CHARTER SCHOOL

*Affordable charter  
school real estate  
in New York*

### FLEXCAP

*New homes for  
low-income populations  
across the USA*

<sup>14</sup> Community Development Financial Institutions (CDFIs) are private-sector, financial intermediaries with community development as their primary mission. There are six basic types of CDFIs: community development banks, community development loan funds, community development credit unions, microenterprise funds, community development corporation-based lenders and investors, and community development venture funds. Source: CDFI Coalition, <[www.cdfi.org](http://www.cdfi.org)>.

## Catalytic First-Loss Capital Details

### PROVIDER

Australian Government’s Social Enterprise Development and Investment Fund (SEDIF).

### RECIPIENT

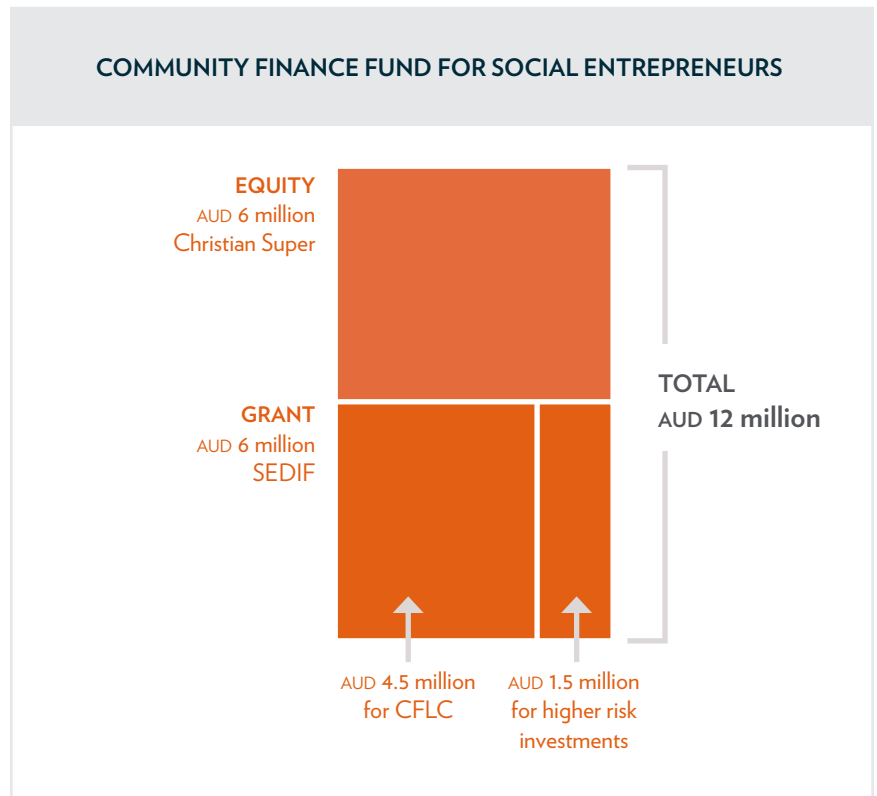
Christian Super, a not-for-profit superannuation fund based in Sydney, Australia.

### AMOUNT AND INSTRUMENT

AUD 4.5 million (or 37.5 percent of the total fund), provided as a grant.

### STRUCTURE AND TERMS

The initial 37.5 percent capital protection is designed to diminish over time as more limited partners invest in the fund. In the first year, the CFLC will cover both interest and principal payments on any loan losses. After that it will cover only the principal component in any losses. If any of the CFLC pool still exists after 30 years, the fund manager can use this money at its discretion.



## Motivations

Because this was a pioneering impact investment deal in Australia, both parties wanted to ensure the deal set a good example in terms of providing financial returns and social impact. The SEDIF grant improved the fund manager's balance sheet, reducing the pressure to hunt for very high returns. From Christian Super's perspective, the CFLC not only brought the opportunity in line with acceptable risk-return parameters, but SEDIF's participation also brought some sector expertise, as the latter has been active in the field for some time.

## Negotiations

Christian Super had done due diligence on the fund manager a few years prior on a similar proposal, but without the CFLC component. Ultimately they decided not to fund them because, though they were achieving positive social outcomes, they were financially not as robust. When the fund manager again approached them with the SEDIF grant program, which was specifically created to catalyze commercial capital toward addressing social issues, Christian Super worked with the two parties to create this transaction. To settle on the ratio of CFLC to its capital, Christian Super began by setting its target floor return and worked backwards to arrive at how much first-loss would be needed to feel secure and meet fiduciary requirements.

## INVESTEES DETAILS

FUND MANAGER	Foresters Community Finance
INCEPTION YEAR	2011
GEOGRAPHIC FOCUS	Australia
TERM	5 Years (until 1 July 2016) with option for Christian Super to extend
IMPACT FOCUS	Provide investors with exposure to a diversified finance portfolio devoted to the social enterprise sector
AUM	AUD 12 million (USD 12.35 million)
FUND CAPITALIZATION	Grant and equity
INVESTMENT PERIOD	Open
INVESTMENT SIZE	Varies
TARGET RETURN	RBA Cash Rate + 1.5%
MANAGEMENT FEES	1.4% fee, 0% carry

## INVESTMENT APPROACH

INVESTMENT INSTRUMENTS	Loans
INVESTMENT PERIOD	3-5 years
INVESTMENT SIZE	Minimum AUD 20,000 (USD 20,700)
TRACK RECORD	AUD 2 million loaned across three transactions, as of 14th August

## Catalytic First-Loss Capital Details

### PROVIDER

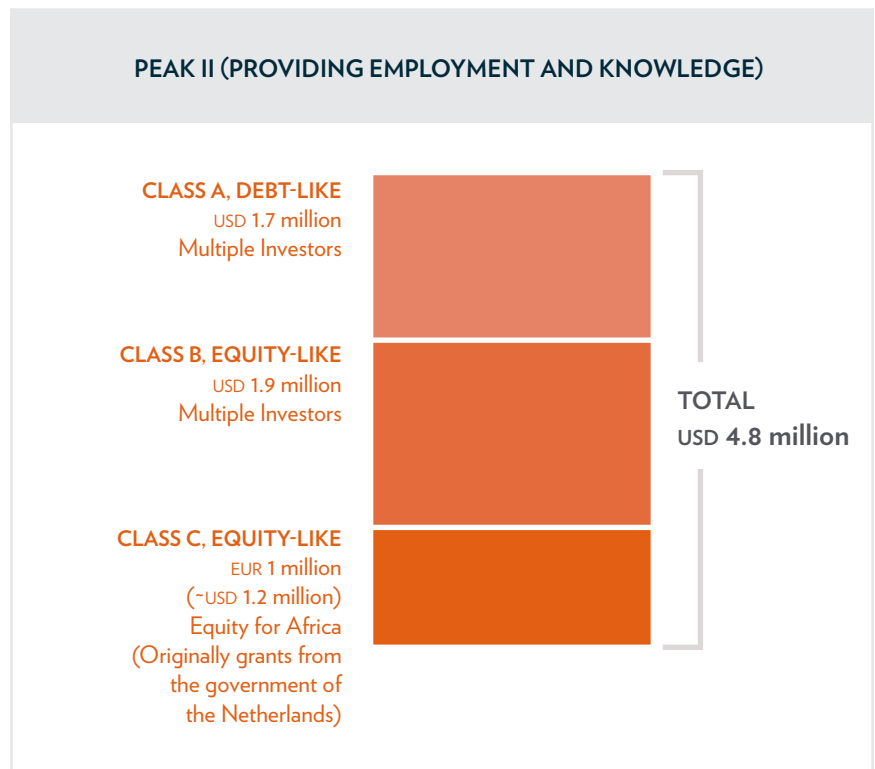
The government of the Netherlands; program managed by FMO, the Dutch development finance institution.

### RECIPIENTS

The fund has three investor classes: A, B, and C. Investors in A & B classes benefit from the protection. These investors include foundations, charities, impact investing funds, and high-net-worth individuals.

### AMOUNT AND INSTRUMENT

EUR 1 million (USD 1.2 million) provided as grant to shareholders in Equity for Tanzania Ltd. (EFTA), then converted into equity (class C shares). EFTA is the fund manager for Peak II.



### STRUCTURE AND TERMS

The fund has three investor classes: A, B, and C. Any losses are completely borne by class C investors first, then B class investors and then by A class investors. Investment proceeds will be distributed first to class A investors, then class B investors, and finally class C investors, until all have received a return of capital + 10 percent. Further proceeds will be shared by class B and C investors. To date USD 4.8 million has been raised from investors in all three classes, so the CFLC comprises 25 percent of the fund. Because the target fund size is USD 10 million, the CFLC will dilute to 12 percent of its fully capitalized amount.



## Motivations

The government of the Netherlands sought to be catalytic, and to support this objective they are also offering technical assistance for underlying Investees in addition to the grant converted to equity for CFLC purposes. For Lundin Foundation—an investor—the fund manager’s micro-asset leasing approach presented a “compelling” impact, but it had limited track record and the nascent space was seemingly high risk. The CFLC allowed Lundin to gain experience in the new market with some downside protection.

The fund manager reflects that the structure has worked very well for this fund, firstly because the CFLC is also utilized for investment, and secondly because, despite the fund manager’s track record, there was still some uncertainty around the exact return levels this relatively young business model would be able to deliver, which this structure cushions.

## Negotiations

The government of the Netherlands provided Equity for Africa, Equity for Tanzania’s parent, with a EUR 1 million grant, which was administered by FMO. The grant was restricted to being invested in the fund’s C class commitments. Once the grant was provided, it was a meaningful enough size for Equity for Tanzania to finalize a variety of investors, some of whom invested in both classes A or B to achieve target risk-return profiles. Lundin Foundation made its commitment conditional on the first-loss capital provision. The foundation determined that the ratio of first-loss to fund size was acceptable based on the fund manager’s track record and its own projections. The capital raise took a long time, and the fund manager reflects that there would also be merits to a “plain vanilla” guarantee with a more recognized structure, which in some cases would have made it easier to market to investors, as it was challenging for investors to categorize the risk.

## INVESTEES DETAILS

FUND MANAGER	Equity for Tanzania Ltd. (EFTA)
INCEPTION YEAR	2012
GEOGRAPHIC FOCUS	Tanzania
TERM	7 years
IMPACT FOCUS	Reduce poverty in Tanzania by empowering entrepreneurs to deliver sustainable employment-intensive growth.
AUM	Current: USD 4.8 million; target: USD 10 million
FUND CAPITALIZATION	Private equity fund with three classes, one debt-like and two equity-like (of which one takes first loss)
INVESTMENT PERIOD	Up to 7 years
INVESTMENT SIZE	Varies
TARGET RETURN	24-28% (Tanzanian Shilling)
MANAGEMENT FEES	PEAK II pays 2% management fee to Equity for Tanzania

## INVESTMENT APPROACH

INVESTMENT INSTRUMENTS	Standardized equipment finance product—financial leases
INVESTMENT PERIOD	3 years
INVESTMENT SIZE	USD 10,000-50,000 (in local currency equivalent)
TRACK RECORD	26 deals approved so far; 15 disbursed, as of October 2013

## Catalytic First-Loss Capital Details

### PROVIDERS

The California Endowment (TCE), JPMorgan Chase Foundation, and the U.S. Treasury’s Community Development Financial Institutions Fund.

### RECIPIENTS

Five banks and one insurance company.

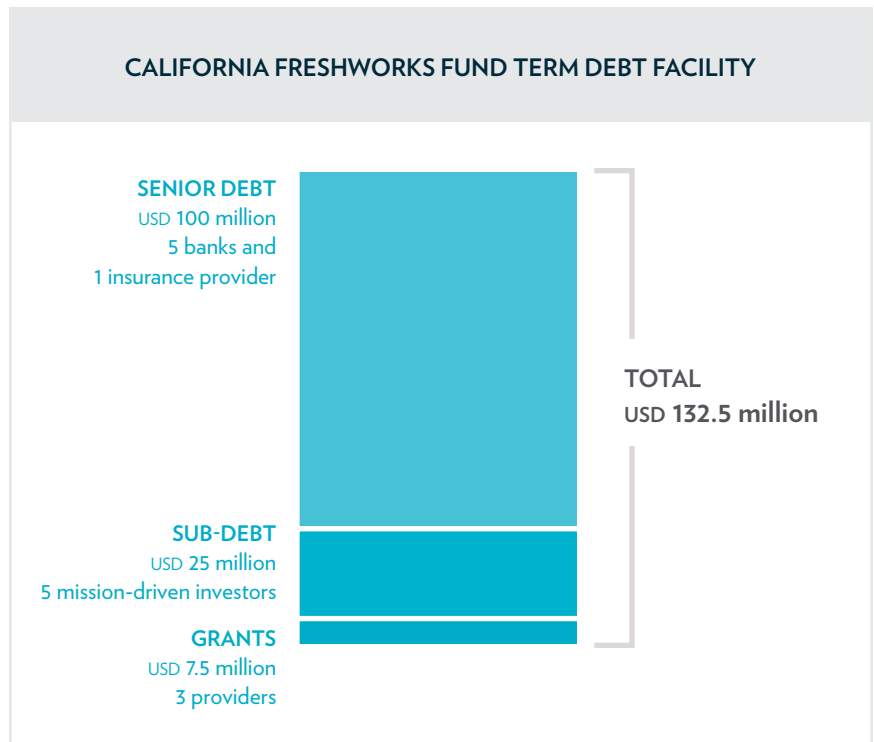
### AMOUNT AND INSTRUMENT

USD 7.5 million provided as grants.

### STRUCTURE AND TERMS

The term debt structure has three layers: USD 100 million in senior debt, contributed by commercial capital investors (five banks and an insurance company); USD 25 million in sub debt, provided by mission-driven investors, including Calvert Foundation, NCB Capital Impact, and TCE; and USD 7.5 million in first-loss capital in the form of grants from TCE, JPMorgan Chase Foundation, and the CDFI Fund. This reserve serves as a first stop-loss for any individual transaction. If there is a loan default, the loss reserve absorbs the full loss related to the loan.

Each loan made from the credit facility is composed 80 percent from the senior tranche and 20 percent from the sub tranche. In the event of a loss, the CFLC fund can be accessed only to make the senior investors whole (not the junior lenders). In theory, if there is a large loss in one transaction, then the full USD 7.5 million can be drawn down in one instance. Alternatively, it could cover numerous small losses until the full amount is exhausted. Losses exceeding the \$7.5 million loan loss reserve would be absorbed by the subordinate investors. At the time of writing this brief, the CFLC fund has not yet been utilized.



*“The fund structure allows Capital Impact to offer flexible loan products that can help grocers enter markets that have traditionally been underserved, while also giving regulated investors the comfort they need to participate in the fund.”<sup>15</sup>*

<sup>15</sup> Dudley Benoit, Senior Vice President at JPMorgan Chase; <http://www.occ.gov/publications/publications-by-type/other-publications-reports/cdi-newsletter/august-2012/healthy-foods-ezine-article-4-ncbci.html>

## Motivations

TCE was interested in catalyzing more financing for healthy food access. It wanted to see its USD 2.5 million grant leveraged, and feels like it achieved a sufficient return, given the overall size of the term debt facility. Interestingly, TCE, which invested USD 2.5 million in the first-loss tranche, also invested in the sub-debt tranche with USD 15 million from its program-related investments (PRI) pool. The JPMorgan Chase Foundation, meanwhile, also provided a third of the CFLC pool, essentially writing down some risk for JPMorgan Chase, which invested USD 30 million in the senior debt pool. TCE also invested in the sub-debt tranche with USD 15 million from its program-related investments (PRI) pool. From the perspective of participating banks, Community Reinvestment Act (CRA) credits presented an additional motivation beyond the risk protection.<sup>16</sup>

## Negotiations

TCE began preliminary discussions with JPMorgan Chase, which were continued by NCB Capital Impact once the latter was appointed as fund administrator. TCE's upfront provision of a grant for CFLC allowed NCB to find impact investors to participate in the sub debt layer. JPMorgan Chase, meanwhile, led the syndication of commercial investors for the senior layer and contributed to negotiations around the amount of CFLC required and the ratio of senior to sub debt. JPMorgan Chase brought market discipline, credibility, and deal structuring expertise that allowed it to talk convincingly and bring in banking peers to the deal. Importantly, the banks saw foundations as investment partners, and the transaction creatively used different types of capital from players who typically do not co-invest (as described above).

<sup>16</sup> The Community Reinvestment Act is intended to encourage depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods, consistent with safe and sound operations. Source: [http://www.federalreserve.gov/communitydev/cra\\_about.htm](http://www.federalreserve.gov/communitydev/cra_about.htm).

## INVESTEES DETAILS

FUND MANAGER	NCB Capital Impact
INCEPTION YEAR	2011
GEOGRAPHIC FOCUS	California, U.S.
TERM	10 years
IMPACT FOCUS	Increase access to healthy, affordable food in underserved communities, spur economic development, and drive innovation in healthy food retailing.
AUM	USD 125 million for loans and USD 7.5 million for first-loss
FUND CAPITALIZATION	Debt and grants
INVESTMENT PERIOD	Up to 10 years
INVESTMENT SIZE	Varies
TARGET RETURN	Senior tranche: ISDA(R) mid-market swap rate plus 225-275 basis points.  Subordinated tranche: A blended rate (based partly on 10-year US Treasury bonds). As of September 11, 2013 the blended rate was 6.65%.
MANAGEMENT FEES	A fixed portion of the grant to cover start-up operational expenses plus a servicing fee on each loan made from the facility.

## INVESTMENT APPROACH

INVESTMENT INSTRUMENTS	Loans
INVESTMENT PERIOD	Up to 10 years
INVESTMENT SIZE	Up to USD 8 million
TRACK RECORD	USD 2.5 million deployed across two transactions, as of August 10, 2013

## Catalytic First-Loss Capital Details

### PROVIDER

Civic Builders (Civic).

### RECIPIENT

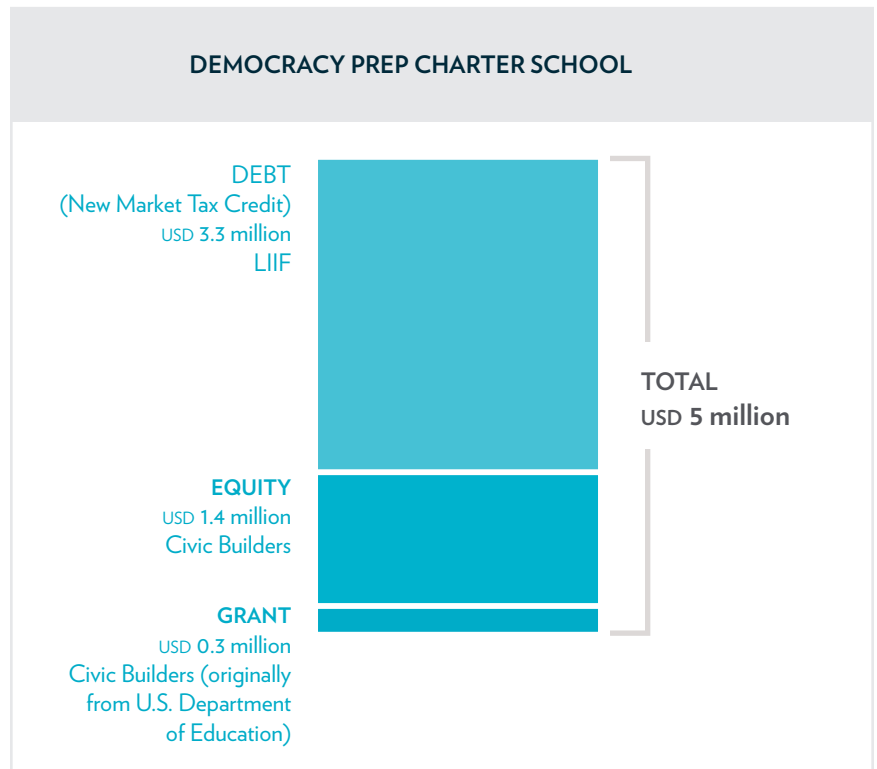
The Low Income Investment Fund (LIIF), a community development finance institution.

### AMOUNT AND INSTRUMENT

USD 300,000 as grant provided by Civic (originally from U.S. Department of Education (USED) credit enhancement facility) as first-loss and USD 1,435,146 as equity from Civic as second-loss.

### STRUCTURE AND TERMS

In 2008, Civic received a USD 8.3 million USED grant dedicated to providing credit enhancement for Civic’s charter school capital projects. Civic uses this money, in conjunction with its own equity investments, in projects it supports. For this transaction it used USD 300,000 from the USED grant and invested an additional USD 1,435,146 of its own capital as equity. Thus, from Civic’s perspective, the grant protects its equity stake, and from LIIF’s perspective, it’s protected by both the grant and equity—so a total of USD 1,735,146. If not used, the credit enhancement funds are released and returned to Civic’s pool of credit enhancement to re-deploy on other projects. The equity served as predevelopment risk capital, or capital that was invested in the project well before any other project capital was secured and funded.



## Motivations

Civic’s goal was to help its charter school partner create “an inspiring yet affordable” space where its students could learn. It continues to partner with the school by maintaining the below-market rent rate and supporting the school with facility-related issues. For LIIF, Civic’s equity in the form of predevelopment risk capital, as well as its development expertise, helped it become comfortable with the project’s risk. Civic’s real estate experience and understanding of the components of charter school success (Civic has deep relationships with many charter schools) gave LIIF confidence that their investment would be used as efficiently and effectively as possible. Last, but not least, the fact that Civic owns the building and that the lease to the school has performance covenants provided further comfort to LIIF.

## Negotiations

In addition to Civic's philanthropic equity and the credit enhancement, the school itself received a USD 363,220 New York State Stimulus Fund grant for general operating expenses, which increased its financial appeal. Weighing the school's academic and financial record, as well as its business structure sustainability, Civic calculated an affordability metric, or a set of ratios, the school needed to meet to be financially viable with strong credit for a lender to provide debt. Factors included operating expenses, cost of real estate, debt service coverage ratios, and liquidity requirements. Based upon this affordability metric, it developed the appropriate scope of work and sourced an adequate capital structure comprised of Civic's equity and LIIF debt.

The negotiations between LIIF and Civic were straightforward. In general, Civic raises capital at a portfolio level on an ongoing basis and invests the capital as needed into individual school projects. These grant funds are distributed over time through the refinancing process and lead to Civic's organizational sustainability while attracting debt investors to its projects. LIIF was excited and motivated by Civic's capital contribution.

## INVESTEES DETAILS

COMPLETION DATE	2008
GEOGRAPHIC FOCUS	Harlem, New York City, U.S.
IMPACT FOCUS	Support a high-quality charter school by transforming a dilapidated church vestry into an appropriate facility for students and teachers while ensuring the affordability and sustainability of a permanent school facility
INVESTMENT SIZE	USD 5,147,040
INVESTMENT CAPITALIZATION	New Markets Tax Credits (NMTC) debt; equity; credit enhancement grant
TARGET RETURN	Civic Builders recycles equity for its projects over time, so its primary goal was to ensure the rent rate was ideally aligned with the school's budget, not a targeted rate of return. LIIF expected a discounted return commensurate with typical NMTC returns.
RESULTS	100% of Democracy Prep Charter School's scholars are African-American or Latino; more than 81% are eligible for free or reduced lunch (which is an indicator of their socioeconomic status); 24% enter with special needs, 12% enter as English Language Learners, and nearly 5% are in New York City's homeless system. The project created 25,500 square feet of school serving approximately 350 students across grades 6-8. Civic has not had a default or delinquency on any assets.

## Catalytic First-Loss Capital Details

### PROVIDER

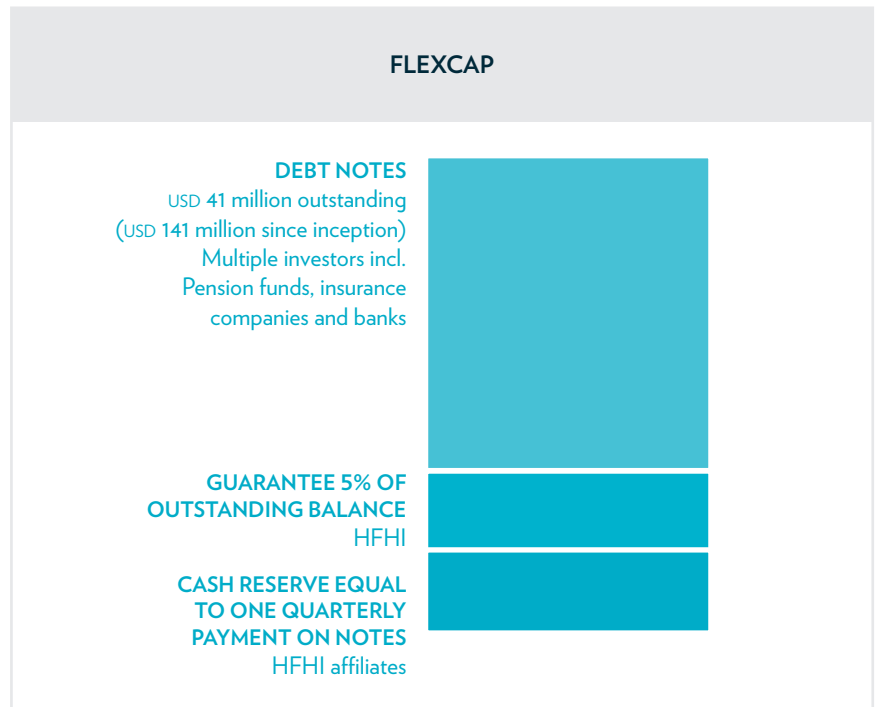
Habitat for Humanity International (HFHI) and Habitat for Humanity affiliates in the U.S. HFHI is the parent organization to the affiliates.

### RECIPIENTS

Various investors, including banks, insurance companies, foundations, and state housing agencies.

### AMOUNT AND INSTRUMENT

The amount varies by transaction and declines over time. The first-loss amount incorporates two elements: the equivalent of one-quarter of principal and interest on the investor notes held in cash reserve (provided by Habitat for Humanity affiliate borrowers) and a guarantee equal to 5 percent of the outstanding balance on investor notes (provided by HFHI).



### STRUCTURE AND TERMS

Affiliates make housing loans to eligible individuals, typically 20-30 year loans at zero percent interest. The FlexCAP program creates a secondary market for these mortgages, enabling affiliates to borrow against mortgages in their portfolios. Through FlexCAP, HFHI issues 7 or 10 year notes to investors, which are secured by a pledge of affiliate mortgages. The interest on FlexCAP notes is typically 3-4 percent. Affiliates select the 7 or 10 year loan term, and loans are sized based upon the discounted value of a 7 or 10 year payment stream from the pledged mortgages. Actual monthly payments from the pledged mortgages are used to make principal and interest payments on the investor notes.

## Motivations

HFHI's long-term goal is to provide low-cost capital to affiliates while maintaining a conservative structure that protects the interests of investors. The FlexCAP program enables affiliates to recover a portion of the mortgage cash-flow stream sooner and to then recycle these into more loans, thus accelerating home-building for low-income populations. For investors, FlexCAP provides access to steady, reliable cash flows, secured by many layers of protection. In addition to the guarantee and cash reserve (described above), investors are further protected by the fact that:

- If a pledged mortgage becomes delinquent, the affiliate is required to substitute a performing mortgage of equal or greater value.
- Affiliates may not pledge more than 60 percent of their performing mortgage portfolios, ensuring that it is not overleveraged and mortgages are available for substitution.
- The loans are full recourse obligations of the affiliates, providing investors eventual access to the participating affiliates' unencumbered assets in the event of a default.

Moreover, since the underlying mortgages are 20-30 years in length, while the notes have a 7-10 year horizon, the present value of the pledged mortgages is typically 200 percent or more of the FlexCAP loan principal at closing, and this ratio increases throughout the term of the investment. Last, but not least, investing banks are able to benefit from Community Reinvestment Act credits.

## Negotiations

HFHI markets FlexCAP offerings to its 1,500 U.S. affiliates that then apply for a loan. HFHI conducts financial due diligence on the affiliate applicants and performs a legal review of every mortgage pledged as collateral. The affiliate notes, together with the underlying mortgage collateral, are pledged by HFHI to investors through an indenture structure. Wells Fargo acts as indenture trustee for the transactions and holds all collateral and administers all loan payments at both the affiliate-HFHI and HFHI-investor levels. The use of standard legal documents minimizes investor transaction costs for note closings.

## INVESTEES DETAILS

FUND MANAGER	Habitat For Humanity International
INCEPTION YEAR	1997
GEOGRAPHIC FOCUS	Throughout the U.S.
TERM	Open-ended
IMPACT FOCUS	Accelerate home ownership for low-income and underprivileged families
AUM	USD 41 million
FUND CAPITALIZATION	Debenture notes
INVESTMENT PERIOD	7 or 10 years
INVESTMENT SIZE	Varies
TARGET RETURN	3.5% on 7-year loans; 4.25% on 10-year loans
TRACK RECORD	A total of 271 Habitat for Humanity affiliates have participated in the FlexCAP program, with 21 investors investing more than USD 141 million since inception. Of the total note issuance, approximately USD 41 million is outstanding and USD 100 million has been repaid. There has been a 100 percent repayment record and zero delinquencies at the investor note level.

## INVESTMENT APPROACH

INVESTMENT INSTRUMENTS	Mortgage loans
INVESTMENT PERIOD	20-30 years
INVESTMENT SIZE	Varies
TRACK RECORD	Funding for over 4,000 new homes has been enabled.

## BENEFITS FOR PROVIDER OBJECTIVES

As outlined earlier (page 7), there are three potential ways Providers can further their missions by providing CFLC—impact acceleration, resource optimization, and terms improvement. These benefits can be variously observed in the five cases described in this brief.

- First, CFLC can help leverage large volumes of capital towards addressing target impact objectives. This is something that applies in all five cases, though the scale of leverage achieved varies from one case to the next. In the CFFSE case, AUD 4.5 million from the Provider catalyzed AUD 6 million from Christian Super, a pension fund. In the FreshWorks Fund case, USD 7.5 million in first-loss grants catalyzed USD 125 million in investment.
- Second, by harnessing sustainable flows of mainstream capital into a particular sector, it can allow Providers to channel their funds into other areas where the commercial case is less proven. This is the goal of Providers in both the CFFSE and Peak II cases; time will tell how successful they are.
- Third, CFLC can improve investment terms for Investees, allowing them to more cost-effectively pursue their intended impact. In the FlexCAP case, due to strong performance over time, investor demand for these notes has increased. As a result, the return offered on these notes has reduced over time, making it cheaper for low-income customers to own new homes. In the FreshWorks Fund case, by structuring its loan pool with a CFLC layer and a subordinate debt tranche, the fund was able to offer grocers loans up to 90 percent of project value, while providing adequate security to senior investors (Typically, a grocer looking to purchase or build a new store can obtain financing for up to 60 percent of the building's value, which often makes investing in new stores financially unattractive or infeasible for the grocer.<sup>17</sup>)

In order to realize these benefits there are several important considerations for Providers to keep in mind, both when structuring, and then managing, transactions incorporating CFLC. These considerations are discussed in the next section.

## Considerations for Providers in Structuring and Managing CFLC Transactions

As mentioned earlier, Providers are the ones in the driver's seat when it comes to catalyzing capital via the use of credit enhancement instruments such as CFLC. There are a number of important considerations for Providers to keep in mind both when negotiating and structuring a potential

<sup>17</sup> Office of the Comptroller of the Currency, Community Developments Investments (August 2012), <<http://www.occ.gov/publications/publications-by-type/other-publications-reports/cdi-newsletter/august-2012/healthy-foods-ezine-article-4-ncbci.html>>.



deal involving CFLC, and while managing the transaction. In combination, these considerations can proactively address the potential risks and downsides identified earlier—specifically, that CFLC might just be “dumb money,” that it might incentivize excessive risk-taking behavior, and that it might distort markets.

## SET EXPECTATIONS UPFRONT

From the Provider’s perspective, the first step in designing a transaction with a CFLC component is to communicate with potential Recipients to understand their constraints and why their capital is not available to the potential Investee. Additionally, the Provider should seek to understand what conditions are necessary for the potential Recipient to provide future capital without credit enhancement. Based on this market feedback, the Provider can determine whether the contemplated CFLC falls under the leverage-for-impact or market development framework and can appropriately size and price the CFLC component for the opportunity.

In parallel, it is paramount that the Provider makes clear its own motivations and intentions up-front, including clear expectations on time horizon and commitments. If, based on market feedback, the Provider aims to catalyze or demonstrate a commercial market, it should communicate this and seek understanding that—if the investment performs—the Recipient will invest with less or potentially no loss protection in the future. Similarly, the Provider should be prepared to make additional, though perhaps diminishing, commitments until the desired market development is achieved.

One Provider noted that it provided CFLC to a fund with the hope of demonstrating a viable market. However, even though the investment performed, the Recipient expected and wanted the same protection terms for the next fund, rather than accepting a decreased level of protection. In the Provider’s view, this was partly because the Provider had not made clear its expectations and objectives upfront.

As the above example illustrates, it is also difficult, in practice, to take something away once it has been provided. The FlexCAP case demonstrates this quite well. Despite strong investment performance over many years, there has been no meaningful change, or reduction, in the amount of loss protection provided. (However, given increased demand for these notes, market forces have led to a reduction in rates of return.)

So, given the twin risks of (a) incentivizing potential investors to predicate investment on CFLC support and (b) counteracting the goals of market development if CFLC is seen as being necessary in the market,<sup>18</sup> the lesson for Providers is to listen to the market, and clearly state and agree upon expectations upfront. This way there is less potential for misunderstanding when subsequent investments are being structured.

<sup>18</sup> Interview with IFC Blended Finance team. See appendix for details.

## STRUCTURE FOR SUCCESS

Ideally, the amount of first-loss protection provided should be no greater than necessary to induce commercial capital to invest, i.e., minimum sufficient to achieve desired goals. Also, from the Provider's perspective, it should be the best use of the capital, i.e., the Providers ought to explicitly evaluate the opportunity cost or what else could be accomplished with the money being considered for CFLC provision. This evaluation applies to both the financial and social/environmental results. These calculations are not always easy to undertake, and often rely on many assumptions, but the exercise is something that's valuable and important to sharpen their expectations for the deal.

The optimal amount of protection is straightforward to determine in theory,<sup>19</sup> but theoretic models alone are not useful in practice without available data to calculate model parameters. The current paucity of data on transactions incorporating CFLC in many sectors makes it difficult to create benchmarks, but more market data over time will certainly help to determine appropriate ranges in practice.

In the cases profiled in this brief, we see that protection levels vary greatly. As one might expect, they would do so by sector, geography, vehicle type, and fund size.

- In the CFFSE case, the Recipient, Christian Super, determined a minimum protection level—based on loss probability scenarios—that would be acceptable to its investment committee. Additionally, it was very important to both Provider and Recipient that there be significant downside protection, because they hoped this transaction would act as demonstration of market potential to other future investors. The negotiation, and these considerations, resulted in a protection ratio of 37.5%. This would decrease as additional investors invest.
- In the Peak II case, the government of the Netherlands provided EUR 1 million for the purposes of CFLC. The fund manager then used this as a starting point to attract other investors and set a target fund size. The current protection ratio is 25%, which would decrease as additional investors invest.
- In the FreshWorks Fund case, the California Endowment got the ball rolling by committing to a level of CFLC protection. NCB Capital Impact, once appointed as administrator, completed aggregation of other Providers in the CFLC layer. In parallel, JPMorgan Chase—one of the Recipients—led the process of syndicating investors in the senior layer and determining the size of the subordinated debt layer. The negotiation resulted in a protection ratio of 6%.
- In the Democracy Prep case, the Provider and the Recipient engaged in a straightforward negotiation, in which the Provider brought to the table some combination of grant and equity, and the Recipient brought debt. The negotiation resulted in a protection ratio of 5.8%.

<sup>19</sup> Using classical asset pricing models such as the CAPM (Capital Asset Pricing Model), for instance. The CAPM is a model that describes the relationship between risk and expected return and that is used in the pricing of financial securities. Per the CAPM, the expected return of a security equals the rate on a risk-free security plus a risk premium. Source: Investopedia, <[www.investopedia.com/terms/c/capm.asp](http://www.investopedia.com/terms/c/capm.asp)>.

- In the FlexCAP case, the initial amount of protection was determined via a multi-party negotiation between all parties involved at the inception of the notes in 1997. Thereafter, new investors came in on the same terms as existing investors. The negotiation resulted in a protection ratio of a little above 5%.

Given the small sample size of just five cases, it is difficult to draw broad conclusions about drivers behind protection levels. It is likely that there are multiple factors at play. And it's also worth noting that in some transactions the levels will change over time, specifically being forecast to decrease upon successful capital raises from additional investors, as is the case in both the Peak II and CFFSE funds.

Ultimately, it is likely that the level of CFLC protection in any given transaction will be a negotiated term derived from the natural tension between the Provider's budget and goals for impact, and the Recipient's risk-return objectives and mission-alignment. And, to the extent that parties are candid about their expectations and goals, a process of negotiation will lead to determining the minimum amount of CFLC needed to complete the transaction.

## ALIGNMENT ON GOALS

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*“Values alignment is critical when using first-loss capital, because you’re locking yourselves together for years.”*

**TIM MACREADY, CHIEF INVESTMENT OFFICER, CHRISTIAN SUPER**

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Many market participants feel that it is important for both the Provider and Recipient to be aligned on non-financial objectives given that their typical relationship may span years. Both should ensure that tools and processes to measure and track impact are in place at the outset. Ideally, the social mission of the investment should be “clearly defined and protected through the governance structure.”<sup>20</sup> From the Recipient's perspective, this is particularly important to maintain its credibility with the Provider, who is expecting achievement of social and/or environmental goals to justify its position in the investment. However, not everyone thinks goals alignment, while helpful, is necessarily critical. One Provider noted that they would be willing to work with a mainstream investor that may not share its social and/or environmental objective, but whose participation would nonetheless further progress towards achieving this objective.

## VISIBILITY

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*Particularly from the Recipient's perspective, visibility around social and/or environmental outcomes can mitigate against possible reputational risk, i.e., being seen as leveraging philanthropic dollars simply to improve one's own financial outcomes.*

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20 UK Cabinet Office, Achieving social impact at scale: Case studies of seven pioneering co-mingling social investment funds, May 2013.

For Providers seeking to demonstrate the viability of a new market, demonstration effects need to be widely and easily disseminated.<sup>21</sup> Providers should ensure that they have a strategy in place to communicate the achievements to a broad audience. For example, Christian Super and SEDIF hope to demonstrate that financial services for lower-income populations in Australia offer a viable market. The fund's results, therefore, need to be shared transparently and pro-actively in order to attract the interest of other investors to this market.

The role of visibility in attracting new investors is amply demonstrated by the successes of both FlexCAP and Civic Builders. FlexCAP has managed to raise significant volumes of capital from new investors over the years (in addition to repeat investments from existing investors), allowing it to reduce the cost of capital needed for constructing homes for low-income populations. Civic Builders, through driving awareness of its work with various charter schools nationwide, was able to win an important funding commitment from the US Department of Education, which will allow it to even more effectively leverage first-loss capital to support quality improvements at more charter schools nationwide.

Last, but not least, the demonstration of non-financial achievements can justify the use of CFLC to various stakeholders. Particularly from the Recipient's perspective, visibility around social and/or environmental outcomes can mitigate against possible reputational risk, i.e. being seen as leveraging philanthropic dollars simply to improve one's own financial outcomes.

## MULTI-LAYER INVESTING

In the FreshWorks Fund case, the JPMorgan Chase Foundation provided a USD 2.5 million grant as CFLC and JPMorgan Chase invested USD 30 million in senior debt. Here different entities within the JPMorgan Chase family, using their respective available instruments, collaborated to satisfy each unit's risk-return profile and accomplish a shared goal. Similarly, in addition to providing a grant as part of the CFLC pool, the California Endowment also invested USD 15 million in the sub-debt tranche.

This type of multi-level investing on the part of a single institution may be particularly attractive to foundations, which can provide credit enhancement using their grant or program-related investment (PRI)<sup>22</sup> funds and invest in more senior positions using their PRI or endowment allocations.

<sup>21</sup> Interview with IFC Blended Finance team. See appendix for details.

<sup>22</sup> In the US program-related investments (PRIs) are investments made by foundations to generate specific program outcomes. Like grants, PRIs make inexpensive capital available to organizations that are addressing social and environmental challenges. Unlike grants, PRIs are expected to be repaid, often with a modest, risk-adjusted, rate of return. Once repaid, the money used for a PRI is recycled into new charitable investments. Source: Mission Investors Exchange, <<https://www.missioninvestors.org/mission-investing/program-related-investments-pris>>

## SUMMARY OF CONSIDERATIONS

As discussed earlier, Providers are faced with certain concerns when it comes to providing CFLC. By evaluating and learning from previous uses of CFLC, appropriately setting expectations upfront, and negotiating structures containing the appropriate amount of CFLC with aligned Recipients, potential Providers can pro-actively address these concerns.

In the Freshworks Fund transaction, the California Endowment invested USD 2.5 million in the first-loss pool, which helped leverage USD 125 million from other investors. From the California Endowment’s perspective, this was very successful leverage. Thus, rather than being seen as “dumb money” that simply provides benefits for others without any benefits for oneself, this case demonstrates that CFLC can help Providers attract large volumes of capital towards addressing social or environmental causes they care about.

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*The Provider’s objective is not to structure all the risk out of a particular investment; the goal is to provide just enough protection to entice investment and then let market forces (i.e., investment performance) drive future transaction terms.*

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Similarly, by seeking alignment on impact goals and by ensuring only enough CFLC is provided to entice investment, Providers can minimize the potential for inappropriate risk-taking behavior by Recipients. As has been exemplified in the FlexCAP case, the Provider’s objective is not to structure all the risk out of a particular investment; the goal is to provide just enough protection to entice investment and then let market forces (i.e., investment performance) drive future transaction terms. Further, if the Provider is able to invest in multiple layers—i.e. in a senior layer in addition to the first-loss layer—then it can work to ensure alignment and balance (to the extent that they may diverge) between the incentives of different players in different layers.

Finally, clear expectations-setting is important so that Recipients don’t come to expect that credit enhancement will be an automatic feature of future deals, especially where it’s no longer warranted. Combining this mutual understanding with external visibility around transaction performance can engender interest from other investors which, in turn, will lead to the establishment of market-driven parameters—as has happened in the FlexCAP case—and militate against the risk of market distortion.

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*Clear expectations-setting is important so that Recipients don’t come to expect that credit enhancement will be an automatic feature of future deals, especially where it’s no longer warranted.*

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# Concluding Thoughts

Credit enhancement is a common feature of financial markets more broadly, and not something particular to impact investing. While the application of credit enhancement to the impact investing market requires careful consideration to motivations and structure, the broader principle of risk mitigation is one upon which much of the mainstream economy also rests.

Catalytic first-loss capital is one specific credit enhancement tool in the impact investment market, one which can play an important and promising role in the growth and expansion of the market, with benefits for both Providers and Recipients. From the Provider's perspective, CFLC can significantly accelerate positive social and environmental impact by leveraging large volumes of capital. It can also draw mainstream investors into markets where they haven't previously invested and, consequently, allow Providers to channel their own capital towards other areas where the commercial case is less proven. Finally, by reducing investment risk, CFLC can help improve terms for Investees. From the Recipient perspective, CFLC can both expand the universe of potential investment opportunities and allow them to gain expertise in, and exposure to, new markets before competitors.

Of course, there is no such thing as a free lunch, and there are potential concerns around providing CFLC that need to be proactively and responsibly addressed by Providers, and also by Recipients. Proper expectations-setting and sound structuring are two important steps in doing so.

All in all, greater understanding and appreciation of catalytic first-loss capital will lead to more efficient and effective use of the tool in the impact investment market. Further data-sharing on performance, management, and results of CFLC transactions is needed to better match capital across the risk-return spectrum and help businesses and markets scale, and we encourage investors to share such information with the GIIN for the benefit of the industry at large.

# Appendix

Detailed considerations for Providers and Recipients deliberating participating in a transaction incorporating CFLC.

Note: These questions are not intended to serve as a substitute for professional due diligence.

## FOR PROVIDERS:

### What is the Recipient's motivation?

- How motivated are the Recipients to participate, and what does that indicate about their commitment to the investment and/or longer-term interest in the target market?
- How aligned are we on impact objectives? How could that affect the impact I hope to achieve?
- Does the Recipient see this market/sector/business model as a potential long-term opportunity? Are they likely to invest again with reduced or no CFLC if results of this investment are positive?

### How can I ensure my objectives are met?

- Why hasn't the market or product attracted commercial investment thus far? Are these barriers best addressed by CFLC provision, technical support, and/or need macroeconomic and political change?
- What problem am I trying to address? Is CFLC the right tool? In what ways can CFLC reduce risk more effectively than a general grant or a risk-sharing product?
- What do I need to communicate upfront if I expect that in the future the commercial investor will invest with less protection and—eventually—with no protection? Is it useful to negotiate and express my expectations for any future partnerships upfront?
- Do I have the requisite governance rights (influence and checks/balances) to ensure my opinion counts in the Investee's strategic decisions?
- Ex post, how will I know if I've achieved my desired change? How can I measure my influence?

## How can I create an effective incentive structure?

- How can I structure the CFLC so it does not encourage imprudent risk-taking by the Recipient?
- Under what circumstances do I want the first-loss capital to be used by the Investee? E.g. can it be used all at once in the event of one large loss or be used only as a certain percentage of each loss, etc., and how does that affect the Investee and Recipient's incentives?
- If the first-loss pool is depleted, what signal might this send to the market?

## FOR RECIPIENTS:

### What is the provider's motivation?

- Is the Provider using an investment or grant to provide CFLC? Do I prefer one over the other? Why?
- How specific are their impact objectives, and are they measurable or easily communicated? What impact, if any, might this have on my ability to achieve my financial objectives?
- Have I partnered with this type of investor before? If government, what are its political motivations and constraints? If foundation, what is the mission it must demonstrate working toward? If high-net-worth individual, what are his/her goals?

### What is the provider's reputation and value-add?

- Is the Provider reputable and credible? Do I trust it to provide the CFLC when it is needed? Am I comfortable entering into a long-term partnership with it?
- Does the Provider have specific knowledge my team lacks (in terms of sector, business model, region)?

### How can I ensure my objectives are met?

- How can I manage the potential reputational risk that may come from the perception of leveraging CFLC to improve my risk-return profile?
- How is the CFLC structured? Does it dilute over time with additional investors? Can it be depleted with one large loss?



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## AUTHORS

Various members of the GIIN team contributed to this report. The lead authors were Amit Bouri and Abhilash Mudaliar.

Others who made important contributions were: Giselle Leung, Melody Meyer, Kimberly Moynihan, and Luther M. Ragin, Jr. Min Pease, former Research Associate, also contributed to this piece.

If you have any questions or comments regarding the report, please contact Abhilash via [amudaliar@thegiin.org](mailto:amudaliar@thegiin.org). We'd also encourage market participants interested in participating in/contributing to future GIIN research products to contact Abhilash.

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*Gurmeet Kaur*

*Head, Impact Investments*

**Christian Super**

*Tim Macready*

*Chief Investment Officer*

**Christian Super**

*Jai Sharma*

*Analyst (Impact Investment/Ethics)*

**Civic Builders**

*Ashley Dills*

*Vice President of Business Development and Finance*

**Council on Foundations**

*Laura Tomasko*

*Network Developer*

**Deutsche Bank**

*Asad Mahmood*  
*Managing Director of the Global Social Investment Funds*

**Enterprise Community Partners**

*Abby Jo Sigal*  
*Senior Vice President, Innovations*

**Equity for Tanzania**

*Madeleine Anderson*  
*CEO*

**FMO**

*Lilian Saade Hazin*  
*Capacity Development Officer, Financial Institutions*

**Habitat for Humanity International**

*Gregory Skowronski*  
*Director of Capital Markets and Financial Systems*

**IDB-MIF**

*Susana Garcia Robles*  
*Principal Investment Officer*

**Inter-American Development Bank**

*Susan Olsen*  
*Lead Specialist, Opportunities for the Majority*

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*Kruskaia Sierra-Escalante*  
*Acting Head of Blended Finance*

**JPMorgan Chase**

*Sean Birney*  
*Vice President, Community Development Banking - Intermediaries Lending*

**JPMorgan Chase**

*Amy Bell*  
*Executive Director, Social Finance*

**JPMorgan Chase**

*Glenn Rockman*  
*Vice President, Social Finance*

**JPMorgan Chase**

*Tripp Shriner*  
*Associate, Social Finance*

**Low Income Investment Fund**

*Judith Kende*  
*Senior Vice President, Eastern and Central Regions*

**Lundin Foundation**

*Stephen Nairne*  
*Managing Director*

**NCB Capital Impact**

*Catherine Howard*  
*Senior Program Manager*

**Prudential Social Investments**

*John Kinghorn*  
*Director, Social Investments*

**Shared Interest**

*Donna Katzin*  
*Executive Director*

**The California Endowment**

*Tina Castro*  
*Director, Impact Investing*

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*Ben Hubbard*  
*Director*

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