The article below is excerpted and condensed from an issue brief on catalytic first-loss capital published by the Global Impact Investing Network.

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 opportunity’s novelty. Innovative credit enhancement, which is a common feature of traditional financial markets, can encourage the flow of capital to these investment opportunities by improving their risk–return profiles and thus incenting more investors to coinvest.

AN INNOVATIVE TOOL TO REDUCE RISK AND CATALYZE IMPACT

Catalytic first-loss capital (CFLC) is one particular credit enhancement tool that has gained prominence of late. Impact investors are experimenting with CFLC in innovative ways to reduce risk, advance social and environmental objectives using commercial capital and stimulate investment activity in new markets.

CFLC, which can be incorporated into a capital structure via a range of instruments, including grants, equity, subordinated debt and guarantees, is best defined by two key features. First, it is catalytic: By improving the recipient’s risk-return profile, CFLC catalyzes the participation of investors that otherwise would not have participated. Second, it is purpose-driven: CFLC aims to channel commercial capital toward the achievement of certain social or environmental outcomes. In addition, often—though not always—the purpose can be to demonstrate the commercial viability of investing into a particular market.

Providers are the chief protagonists of CFLC in impact investing: Their ability and willingness to offer protection to other investors are the most important factors in driving greater capital flows via such structures. Providers tend to be strongly aligned with the investee’s social or environmental goals and theory of change. Additionally, they are willing to take on greater financial risk in return for driving toward target nonfinancial objectives. Given these characteristics, foundations are particularly well-positioned to play the role of CFLC provider.

BENEFITS FOR BOTH PROVIDERS AND RECIPIENTS

Providers and recipients both can benefit in various ways by participating in CFLC transactions.

The primary benefit for providers is that CFLC can enable them to leverage far greater volumes of capital to address target social or environmental challenges than they could mobilize on their own. To the extent that the opportunity is not seen to have potential to become commercially viable in the foreseeable future, continuous and ongoing credit enhancement will be required to maintain the inflow of commercial capital. In some cases, however, CFLC can help bridge information asymmetries and help develop new markets. Some investors, such as foundations and governments, often have considerable experience in certain sectors and regions where more risk-averse investors, such as banks or institutional investors, have limited experience. Investors unfamiliar with these markets may

“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.”

—Dr. Judith Rodin, president The Rockefeller Foundation
believe investment risks to be greater than they actually are, and may thus be unwilling to invest.

A second benefit of CFLC, then, is to draw those investors into the market and demonstrate its financial viability: If the investment performance is sound, it can lead investors to alter their risk-return expectations and to subsequently reinvest in the same market with reduced, or potentially no, credit enhancement. By doing either or both of the above two – achieving leverage and demonstrating commercial viability – a third benefit for providers is that they can channel more of their own scarce capital toward other areas where the commercial case is less proven. Last, but not least, CFLC helps improve the terms at which investees can access capital.

For their part, recipients may benefit in a couple of ways. First, though they may be motivated by an investment’s potential social or environmental impact, they may be subject to meeting specific risk–return bounds, including those imposed by fiduciary constraints. In the absence of credit enhancement, certain impact investment opportunities may fall outside these bounds. By reducing recipients’ potential loss from an investment, CFLC improves the risk–return profile of an opportunity enough to incent or enable recipients to invest, thus expanding their universe of potential investment opportunities. 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. Moreover, by investing with CFLC, recipients can gain first-mover knowledge of a new or nascent market, with the comfort of some downside protection.

It’s important for providers to understand that it’s often valuable, when trying to entice others to wade into uncharted waters, to present them with an opportunity to dip their toes first rather than requiring them to plunge right in. CFLC enables this in a very pragmatic way.

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<th>RECIPIENTS (INVESTORS)</th>
<th>INVESTEES (FUNDS, MISSION-DRIVEN ORGANIZATIONS, PROJECTS)</th>
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<td>Protected by credit enhancement/first loss</td>
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<th>PROVIDERS (INVESTORS AND GRANTMAKERS)</th>
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<td>Take first loss or subordinated position</td>
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FIGURE 1: RECIPIENTS AND PROVIDERS OF PROTECTION
Investing to Protect the World’s Climate

The following foundations have pledged to divest from fossil fuel companies and invest a portion of their assets in the clean energy economy under the Divest-Invest Philanthropy initiative:

- Ben & Jerry’s Foundation, Inc.
- The Chorus Foundation
- Compton Foundation
- The Educational Foundation of America
- Granary Foundation
- Jessie Smith Noyes Foundation
- The John Merck Fund
- Joseph Rowntree Charitable Trust
- KL Felicitas Foundation
- Nia Community Foundation
- Park Foundation, Inc.
- The Russell Family Foundation
- The Schmidt Family Foundation
- The Sierra Club Foundation
- Singing Field Foundation
- Solidago Foundation
- Wallace Global Fund

For more information, please visit http://www.divestinvest.org/philanthropy.

Amit Bouri is managing director and Abhilash Mudaliar is research manager at Global Impact Investing Network. The full issue brief on catalytic first-loss capital is available for free download at www.thegiin.org.

Notes

1. Dr. Rodin’s keynote address during the G8 Social Impact Investment Forum, held in London on June 6, 2013.