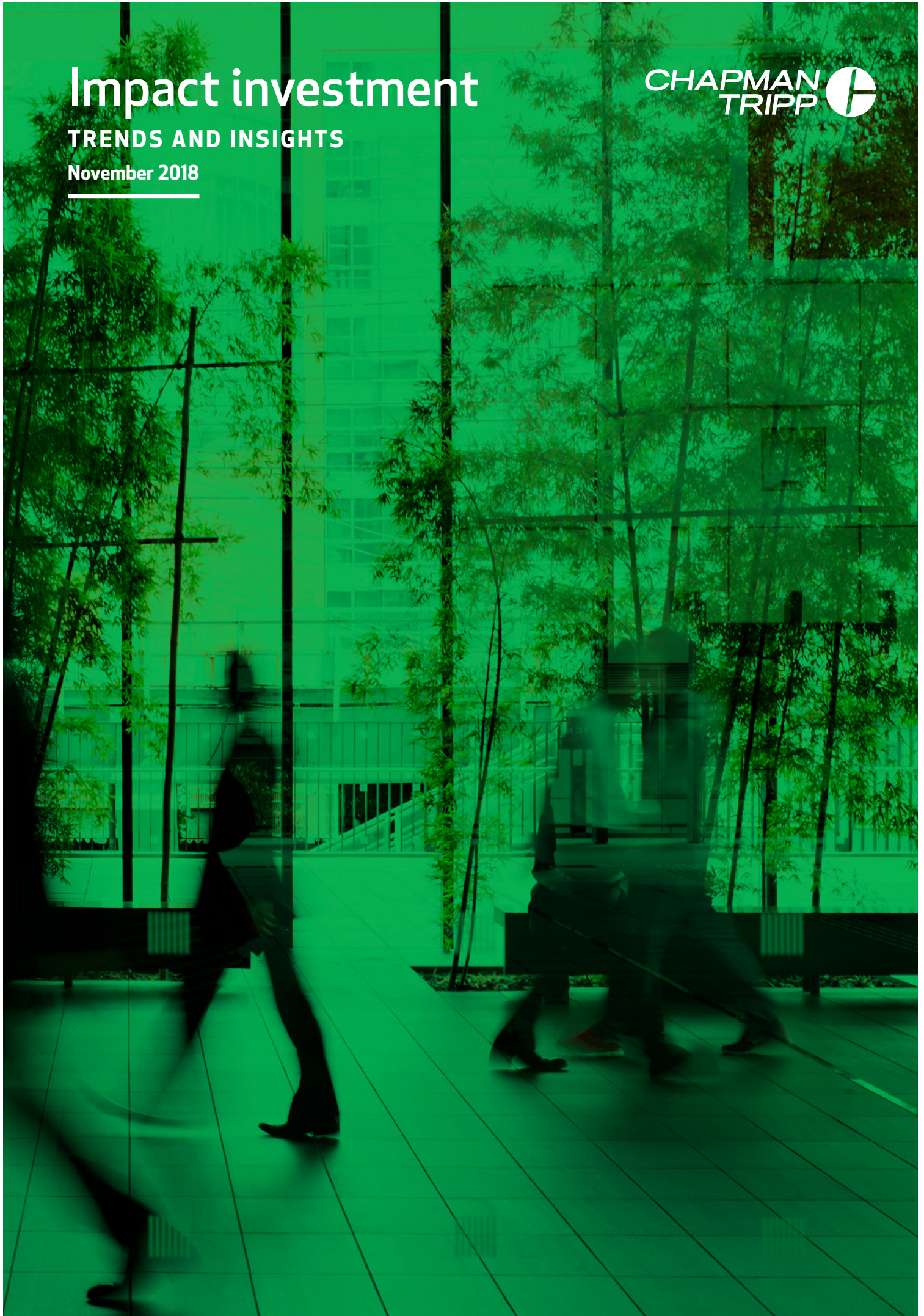



Impact investment

TRENDS AND INSIGHTS

November 2018

CHAPMAN
TRIPP 





Impact investing is
“investing with the
intention of generating
a measurable and
beneficial societal
and/or environmental
impact alongside a
financial return”.

Impact Investing Network,
Aotearoa, New Zealand

NZ Law Firm of the Year

Chambers Asia-Pacific Awards 2018

Most Innovative National Law Firm of the Year (New Zealand)

IFLR Asia Awards 2018

New Zealand Deal Team of the Year

2017, 2016 & 2015 Australasian Law Awards

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Impact investment on the up and up

Impact investment can take a variety of forms – green bonds, social bonds, strategic philanthropy, ethical funds management, social enterprise, to name a few – but it has a common organising principle, which is to generate social and environmental benefits alongside a financial return.

Impact investment is not new but some of the nomenclature around it is, as are some of the instruments; and it is now an idea whose time has come. Globally, it is on the up and up, and in New Zealand too, although off a very low base.

The Global Impact Investing Network (GIIN) estimates the worldwide asset value of impact investments to be around US\$228.1b, of which US\$35.5b was committed in 2017.

Social and environmental impacts are harder to measure than financial returns, but increasingly sophisticated measurement tools are being developed. Among the most respected are Bridges Impact Management Project, the UN's Sustainable Development Goals, and the GIIN's Impact Measurement & Management framework.

The Impact Investing National Advisory Board Aotearoa New Zealand has recently joined the Global Steering Group for Impact Investing, with the goal of connecting New Zealand to international markets and gleaned knowledge to apply to our local economy.

Government leading by example

The Wellbeing Budget, to be presented next year, is an important step toward impact investment by central Government. It will report against a broader set of indicators than economic growth and will promote social wellbeing and environmental values in budget decision-making. Former Finance Minister Bill English's Integrated Data Infrastructure, providing microdata on people and households¹ is a key component of this new approach.



WHY BUSINESSES NEED TO KNOW ABOUT IMPACT INVESTMENT:

Consumers and investors are demanding change. This will intensify as the millennial generation enters the investment sphere.

Significant global asset management firms and banks, including Goldman Sachs and Credit Suisse, are moving toward impact investment to meet client expectations.

Companies will have a first-mover advantage as jurisdictions around the world start to address issues such as climate change.

ESG factors improve returns over the long term. Venture capitalist and private equity investor Sir Ronald Cohen believes social entrepreneurs can also be billionaires.

¹ Integrated Data Infrastructure – <https://www.stats.govt.nz/integrated-data/integrated-data-infrastructure/>

Impact investment

– trends and predictions



The good

Rapid increase in focus and funding in the impact investment area



The challenges

Measurement of outcomes including attribution and generating a pipeline of deals



The opportunities

Making the most of our clean/green image and encouraging offshore recognition and investment

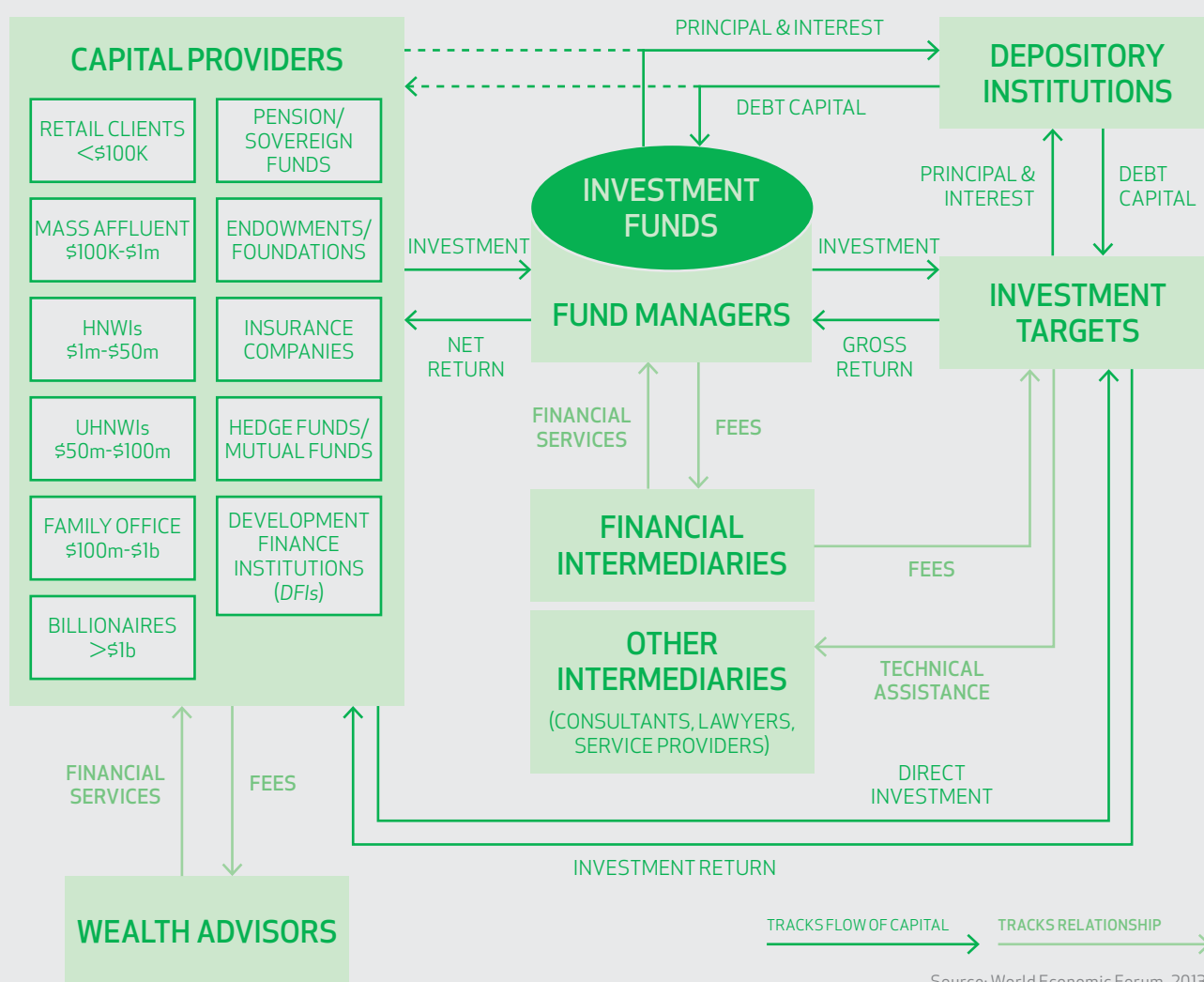
Impact investing is relatively undeveloped in New Zealand in comparison with other jurisdictions but a number of factors are at work which we expect will close that gap.

Predictions for the year ahead

- A public groundswell for change as consumers insist that their social and environmental priorities are reflected in, and advanced by, their investments.
- In particular, New Zealand is on the verge of a green bonds growth surge as increased investor social and environmental awareness meets more sophisticated capability in the finance sector.
- Philanthropists and charitable foundations will increasingly pursue strategies that seek measurable social and environmental benefits from their investments.
- Demand for responsible investment products will increase as younger investors seek to align their portfolios with their personal beliefs and convictions.
- Listed companies in New Zealand will be forced to focus more on environmental, economic and social sustainability (ESG) principles in response to global and local investor demand.
- The uptake of social bonds will be slow in the near-future but the investment made in developing the model can deliver dividends over the longer-term.
- Institutional investors will seek environmental and social benefits but will also expect a market rate return.
- Iwi will continue to balance financial returns with social and cultural outcomes in their investment decisions.

THE IMPACT INVESTMENT ECOSYSTEM

Impact investment has been a great example of market-led innovation. Regulation and regulators have taken a back-seat role in developments.



Data: The fuel for this ecosystem is data. Responsible investment, to some extent, is constrained by the data available. A pragmatic approach has been taken by the market in resolving this, for example by reference to best available proxies – with criteria specifically designed to evolve towards higher standards on specified time frames, as better data becomes available.

Green bond market about to achieve lift-off in New Zealand

The green bond market in New Zealand is undeveloped by comparison to equivalent jurisdictions, potential investor interest and the Government's ambitions. But every indication is that we are about to experience a growth surge.

The international picture

The first green bond was issued in 2007 in the US but it was not until 2013 that the market got a real adrenalin shot. Issuance more than trebled since that year and this momentum has been sustained.

Investment in green bonds had reached US\$221b by the end of 2017. While significant, this is a small fraction of the US\$100tr global bond market – indicating that there is still substantial growth potential.

This has been accompanied and encouraged by a growing diversity of products and issues, including sustainability bonds, green project bonds, and the entry of corporate bonds and securitisation vehicles.

Australia has echoed the global story. It issued its first World Bank green bond in 2014 and now has A\$8.3b under issue.

Push factors behind a growth surge in New Zealand

Timing is right for a focus on green bonds.

- The Productivity Commission has recommended a meaningful carbon price in its Low Emissions Economy final report, and the Zero Carbon Act will back this up legislatively.
- There is growing commitment to ESG principles in both the private and public sectors, with the Government planning to release the world's first Wellbeing Budget in 2019.
- There is enormous untapped demand, locally and internationally. New Zealand's infrastructure investment pipeline has never been larger and climate change effects are generating a new urgency around addressing our infrastructure deficit, increasing resilience, and ensuring environmental sustainability.

- Tools for impact assessment are improving, as are certification and transparency standards.
- New Zealand Stock Exchange (NZX) is introducing a green bond flag for investors, and a centralised location for green reporting in New Zealand.

Catalysing the market

The OECD and the New Zealand Productivity Commission each recommend a coordinated regulatory response to catalyse green investment. Auckland Council's decision to use a full certification/PDS process for its green bond was also informed by a desire to promote green bonds as a capital raising option.

Multilateral development banks (MDBs), such as the World Bank, IFC and KfW, have taken an active and deliberate role in propelling the green bond market forward. For example, in establishing its green bond programme, KfW noted:

"It is our mission to broaden the spectrum of investors and to bring the green-bond market out of the niche into the mainstream, and therefore we use our global presence in capital markets to reach this goal."

WHAT ARE GREEN BONDS?

Green bonds are conventional bonds except that the proceeds are applied towards projects that generate positive environmental benefits or help the community adapt to the effects of climate change.

Issued off regular debt programmes, they are priced and behave like their vanilla counterpart in most respects. The differences are in investor focus and approach and in the ESG engagement, they can offer internally and with investors.

Green bond market about to achieve lift-off in New Zealand *(continued)*

MDBs contribute not just through issuance but also through standard setting, for instance by membership on the Green Bond Principles (GBP) executive committee.

We can see room for sector-specific green-focused initiatives to link to capital investment markets:

- there is scope for convergence between Green Star building ratings (for new or refurbished commercial buildings) and the issue of real estate-flavoured green bonds (i.e. property syndications that fund 5 or 6 Green Star rated assets),
- several green commercial mortgage backed-securities (CMBS) have been issued in Australia, and
- in February this year, the National Australia Bank issued a A\$300m green tranche in its A\$2b residential mortgage-backed security (RMBS) issue.

GREEN BONDS IN NEW ZEALAND



\$100M KAURI GREEN BOND (JULY 2017)

FIRST GREEN BOND ISSUE – A WHOLESALE SSA-ISSUED KAURI BOND.

INTERNATIONAL FINANCE CORPORATION LAUNCHED ITS GREEN BOND PROGRAMME IN 2010 “TO HELP CATALYSE THE MARKET” AND HAS SINCE ISSUED US\$5.8B IN 12 CURRENCIES.



\$200M RETAIL ISSUE (JULY 2018)

FIRST RETAIL ISSUE LISTED ON NZX. CAPITAL WILL FUND LOW EMISSION TRANSPORT (ELECTRIC TRAINS). RAISED THROUGH A PRODUCT DISCLOSURE STATEMENT (PDS) ALTHOUGH AUCKLAND COUNCIL IS ELIGIBLE FOR THE SAME CLASS REGIME.



CONTACT ENERGY HAS HAD ITS EXISTING DEBT PROGRAMME CERTIFIED BY THE CLIMATE BONDS INITIATIVE, RESULTING IN A \$1.8B GREEN BORROWING PROGRAMME TO FUND ITS GEOTHERMAL GENERATION ASSETS.



PART OF ANZ'S GREEN BOND POOL IS INVESTED IN NEW ZEALAND PROJECTS.

Green bond market about to achieve lift-off in New Zealand *(continued)*

Regulatory treatment

Regulatory regimes in most jurisdictions, including New Zealand, do not distinguish between green bonds and conventional bonds.

Offer documents from the same issuer, in respect of an offer of conventional bonds and an offer of green bonds, will contain largely the same information. Assuming both offers are made at the same time, or there has been no material change in circumstance between when they are offered, the description of the issuer's business, management and risks will be identical.

The important point of difference in the offer document is the use of proceeds disclosure, in that the offer document for green bond offers will describe a purpose that either helps the community adapt to the effects of climate change, or generates positive environmental benefits. The framework will also likely include reporting and accountability requirements.

ELIGIBLE PROJECTS INCLUDE



RENEWABLE ENERGY



ENERGY EFFICIENCY



POLLUTION PREVENTION
AND CONTROL



ENVIRONMENTALLY SUSTAINABLE
MANAGEMENT OF LIVING NATURAL
RESOURCES AND LAND USE



TERRESTRIAL AND AQUATIC
BIODIVERSITY



CLEAN TRANSPORTATION



SUSTAINABLE WATER AND
WASTEWATER MANAGEMENT



CLIMATE CHANGE ADAPTION



ECO-EFFICIENT AND/OR
CIRCULAR ECONOMY ADAPTED
PRODUCTS, PRODUCTION
TECHNOLOGIES AND PROCESSES



GREEN BUILDINGS

Green bond market about to achieve lift-off in New Zealand *(continued)*

Guidelines, standards and assurance mechanisms

Green bonds are supported by a number of opt-in frameworks established by self-regulatory bodies, including industry guidelines, standards and assurance mechanisms and various green bond indices (which also operate as de facto screening). Leading industry standards include the Green Bond Principles, Climate Bonds Standard, and Cicero second opinions.

Green Bond Principles (GBP)

The GBP are a set of voluntary process guidelines which reflect green bond issuance “best practice”. As they are not mandatory, there is no prohibition on issuing a labelled green bond that does not adhere to them rather than another standard – but any green claims will be subject to the fair dealing rules. The proceeds of the green bond must be invested in green or climate-change linked projects which provide clear environmental benefits.

Climate Bonds Standard

The Climate Bonds Standard (CBS) was developed by the Climate Bonds Initiative (CBI), an international organisation working to mobilise the bond market in the fight against climate change. As with the GBP, CBS is a voluntary regime which an issuer may elect to join.

While the GBPs are very general, the CBI’s Climate Bonds Standard is centred on the Climate Bonds Taxonomy – a comprehensive set of sector-specific criteria developed by climate scientists to determine a project’s low-carbon value and suitability, to support the issuance of a green bond.

Assets that meet the CBI standard are then eligible for Climate Bond Certification. To meet the standard, all projects and assets to be funded by the proceeds from the bond must fall within one or more of the eligible investment areas in the taxonomy.

Process requirements under the standard largely mirror those found in the GBPs. The issuer must disclose the bond’s environmental objectives and maintain a process for determining the eligibility of the projects to be funded; and the proceeds of the issuance must be segregated from the issuer’s other funds.

CICERO second opinions

The most popular assurance mechanism in the global green bond markets is the second opinion offered by the Center for International Climate Research in Oslo (CICERO).

CICERO employs a ‘shades of green’ methodology under which a bond may be rated light, medium or dark green to indicate the bond’s alignment with supporting a low carbon resilient future.

CICERO draws on leading climate research to determine the environmental impact of the projects funded by the proceeds of the bond. Unless ongoing review is requested, CICERO opinions are largely issued prior to issuance of the bond by reference to what is intended to occur (not what has actually happened).



CICERO
Shades of
Green



International Capital Market Association



“Clarity about access to the same class offer regime risks becoming perceived as a regulatory barrier, which is likely to hold back issuance.”

Relationship with GBP and CBS

CICERO's second opinions go further than the GBPs and differ from the CBI model in several ways:

- CICERO researchers review green bond frameworks beginning with the GBPs as loose guidance, but push much deeper on the definition of 'green' to assess the potential climate and environmental risks and impacts of proposed projects
- CICERO takes a dynamic approach, without fixed definitions, developing as science and the market evolves. Each green bond framework is reviewed in a tailored manner, with respect to its specific context and issuer, and
- CICERO is an independent research institution which issues its second opinions independently of other stakeholders' influence. This integrity has been valued by the market.

Regulatory support

The Commerce Commission in its Low Emissions Economy Final Report (August 2018) concluded that specific government intervention in the New Zealand green bond market is not required.

It is notable that the evolution of green bonds in other jurisdictions has benefited from more active regulatory involvement. For example, in China and India the market was stimulated by guidelines issued by regulators, which then encouraged issuers to enter the market. Markets in France, the Netherlands, UK, and South East Asia have similarly benefited from a range of interventions, including regulatory requirements as to ESG risk, carbon-efficiency standards and datasets, and development of regionally-focused green bond standards.

To date, participants in the Australian and New Zealand green bond market have not had any formal market infrastructure or policy support – development is driven purely by cost-benefit analysis or by desire to do the right thing. In its August 2018,

Green finance country briefing, CBI notes that creating the project pipeline to meet Paris targets in Australia and New Zealand will ultimately rely on more substantive policy support for green projects and green finance.

These sentiments also have the support of institutional investors. In December 2015, asset managers representing US\$10tr AUM signed The Paris Green Bonds Statement, supporting the growth of green bonds and encouraging:

- governments to act, including through policy, regulation and other mechanisms to support issuance of green bonds
- development of clear and independent industry standards for climate change impacts and benefits of bond financed projects, and
- issues to be transparent about the uses which will be made of the proceeds and their impact, including independent reviews of environmental credentials.

While we agree with the Productivity Commission that there is no need for specific legislation, we consider that regulatory measures could have a significant impact in propelling the market forward. Clarity about access to the same class offer regime risks becoming perceived as a regulatory barrier, which is likely to hold back issuance. If this is so, it would also have a crimping impact on other initiatives – including sharing of information and market experiences – and on removal of barriers, such as the cost of verification, data availability and development of benchmarks and liquidity.

Affirmative statements from the regulator (which could include its expectations around disclosure, accountability and best practice) would also support KiwiSaver, and other institutional investors' engagement in the green bond market.

From donations and grants to strategic philanthropy

The traditional gift to charity is money that, once spent, is gone. Increasingly, however, philanthropists are seeking impact from their giving.

They see their contributions as an investment and they contribute much more than just funds. They are emotionally engaged with the targets of their giving and are concerned to achieve measureable outcomes.

They are advising, teaching and guiding, providing extensive business acumen, and introducing business disciplines from the private sector. They want to bring about tangible social and environmental change in their lifetimes. They are engaged in strategic philanthropy.

Leading proponents in New Zealand are the NEXT Foundation in the educational and environmental spheres and the Tindall Foundation in social investment.

NEXT Foundation: a leader in strategic philanthropy

NEXT Foundation founders, Neal and Annette Plowman, are passionate about education and the environment and want to make a difference. They decided that applying a limited life to the fund would increase its impact – it has a 10-year \$100m “spend down” strategy.

NEXT invests in a small number of multi-year initiatives, giving financial and non-financial support. It has invested in the development of techniques and technology for predator control, in landscape scale environmental sustainability projects such as the regeneration of Rotorua Island, Abel Tasman and Taranaki Mounga, and in the social movement for a Predator Free New Zealand.¹

One of NEXT’s goals is to grow strategic philanthropy in New Zealand. Components it and others have identified to achieve this are:

- looking outward to what is happening internationally to build knowledge and learning
- focusing more on understanding impact, including sharing experience, stories and data
- supporting each other within the generosity community
- promoting collaboration, including with private business and government, and
- broadening the frame of reference from a western construct of philanthropy to include Māori models such as manaaki (to enhance mana) and to explore what makes organised generosity for both giver and receiver in Aotearoa unique.

“Increasingly, philanthropists and foundations are seeking impact from their giving... They are engaged in strategic philanthropy.”

¹ See NEXT Stories, a series of papers published by the NEXT Foundation, available on their website nextfoundation.org in mid-November.

From donations and grants to strategic philanthropy *(continued)*

MAKING A SOCIAL INVESTMENT

Social investments may require the investor to have the constitutional flexibility to invest where the financial return may be lower than an equivalent commercial investment, the risk higher or the repayments less regular.

While Trustees contemplating a social investment fund may be concerned to meet their duty to invest prudently, the tide is moving towards social or environmental impact as a valid measurable return on an investment.

The Tindall Foundation and social investment

The Tindall Foundation, founded by Sir Stephen Tindall, was a key mover behind the establishment of the New Zealand Housing Foundation, which has now built 700 homes and enabled over 100 low-income families to reach full home ownership.

The Tindall Foundation views its investment in the New Zealand Housing Foundation – providing loan funding at a low interest rate or on more flexible terms than would be available in the market – as a social investment, as distinct from a donation or grant. The social returns on the investment are considered alongside the commercial return.

The Foundation also supports the Community Foundation movement, which has over \$100m in managed funds and another \$300m in promised/bequeathed funds.

Authorisation for a social investment isn't quite a dispositive power or a standard investment power but is a hybrid of both. Investments are assessed in terms of their social and/or environmental impact by including non-financial returns such as creating employment and improving health outcomes. This is a sector the world banks and micro-finance lenders have been involved in for years. This blended model is becoming increasingly common internationally and is occurring at a significant scale (gsgii.org).

“The Tindall Foundation has been making social loans and investments for most of its 22 year history. Investing, as well as making donations, allows for capital to be recycled, and to be leveraged to attract other capital. The success of this approach has allowed the Foundation to work at a much larger scale than what could have been achieved through donations alone. Social (or impact) investing has become a key part of the Tindall Foundation's way of supporting innovative social and environmental initiatives.”



John McCarthy
Manager
The Tindall Foundation

From donations and grants to strategic philanthropy *(continued)*

Impact investing and social enterprise

Ākina Foundation is the primary organisation in New Zealand supporting the emerging social enterprise sector. Ākina was established in 2008 by the Tindall and Todd Foundations as a charitable trust to support practical action on climate change and the environment.

What is social enterprise?

Ākina defines social enterprises as purpose-driven organisations that trade to deliver social and/or environmental impact.

There is a broad spectrum of social enterprise, ranging from:

- a charity that partially supports itself through sales, such as a hospice shop, to
- Whale Watch Kaikoura Limited, a charitable company that both invests in the community and returns surplus funds to further charitable purposes in Kaikoura, to
- Eat My Lunch Limited, a tax-paying company owned by private shareholders using the 'buy one give one' model to provide lunches to New Zealand children who would otherwise go without.

The balancing of the commitment to the mission and the level of reinvestment of profit (as opposed to distribution to shareholders) will differ for each social enterprise.

A key issue facing social enterprise is the difficulty finding seed funding. A social enterprise may be established as a charitable organisation if it has charitable purposes, which in theory could attract grant funding. Alternatively it may be established using an ordinary (non-charitable) company structure, which would ordinarily preclude grant funding. Each option has its downsides.

Ākina is currently interviewing subjects to develop a proposal to the Ministry of Business, Innovation and Employment in early 2019 on whether New Zealand's existing legal structures create barriers for social enterprises, and from that determine whether any changes are required to better enable the sector to grow.

It is exciting to watch impact investing in New Zealand transition from an experimental investment option to an accepted and encouraged opportunity that not only delivers desirable financial returns, but also unlocks transformative impact at the same time.

Ākina has been supporting New Zealand's impact investing sector for a number of years now, and in that time has helped numerous organisations raise over \$11m in both debt and equity investment, provided \$150,000 in investment readiness grants to social enterprises (which have so far enabled over \$1,800,000 in investment in the recipients), and supported the creation of Aotearoa's Impact Investing National Advisory Board and its ratification to the Global Steering Group for Impact Investing.

We also continue to work with a growing number of organisations to help them better understand how to both measure impact and manage the impact they are having. This is an essential enabler of the growing number of impact investing opportunities we are seeing in New Zealand, and we thank Chapman Tripp for their commitment to this sector also.



Louise Aitken
CEO
Ākina Foundation

From donations and grants to strategic philanthropy (continued)

Features of social enterprise structures internationally include:

- mission lock, being the extent to which the social or environmental impact is entrenched in the entity's constitutional documents
- asset lock, being the level of restriction on funds flowing back to shareholders, often capped or only permitted following a level of reinvestment
- reporting on achievement of social or environmental goals in a publicly available annual benefit report or management report or to a special-purpose regulator, and
- some form of tax incentive, either for the entity itself or for investors.

Eat My Lunch, one of the more well-known social enterprises in New Zealand, blends social purpose and commercial practices into a single business. Founder Lisa King says not being a charity was a significant disadvantage in the early days when they were looking for funding as a lot of foundations and companies can only give to registered charities. So she looked for more creative ways to assist.

Eat My Lunch was the first company in New Zealand to use the pledge crowdfunding platform for debt raising. In conjunction with the Aera Foundation, started by Derek Handley, Eat My Lunch created a Lunch Bond in 2016, whereby the public were able to lend and every \$1000 earned 6% interest and provided one lunch to a child in need per month during the period of the lending. The crowd funding campaign exceeded its goal of \$500,000 and raised \$815,000.

Aera Foundation went on to be a cornerstone beneficiary of Aera VC, a venture capital investment community backing early stage companies fusing social and financial goals around the world, based offshore.

All investee company founders must commit to a social terms sheet which defines the social purpose and impact metrics alongside financial goals. The founders must also make a 'pay it forward' pledge to specify how they will invest some of their own financial gain towards social, environmental or charitable initiatives.

“A social enterprise is one that is commercially sustainable but with a focus on delivering a positive social impact – in our case, providing healthy school lunches for school kids who would otherwise go without and enabling them to learn. Someone once told me that ‘in order to be a socialist, you must be a capitalist’ – and I think that is particularly fitting with the concept of social entrepreneurship.”



Lisa King
Founder
Eat My Lunch

From donations and grants to strategic philanthropy *(continued)*

Impact Enterprise Fund

A willingness to provide financial support for social enterprise has led to the development of the Impact Enterprise Fund (IEF). The IEF is a joint venture between Ākina Foundation, New Ground Capital Limited and Impact Ventures. It is an \$8m to \$15m fund that will invest in New Zealand businesses which

deliver tangible social or environmental returns along with a financial return. Investees looking for investment need to define their organisation's impact delivery in the form of activities and measurable outputs and outcomes.

"The market is growing so rapidly – and by so much – we are having to review some of the initial aspirations we had with the Fund with respect to the size of investments. More and more social companies are starting to look for money further down the track as well as at early stages, and some therefore require a lot more funds.

At SOCAP (global Social Capital Markets conference) recently, there were discussions about the need for marketplace events that would allow social entrepreneurs to sell their businesses, allowing

them to go on and start the next business, developing greater liquidity in the market for social enterprises. It's not just an issue for us here in Aotearoa New Zealand.

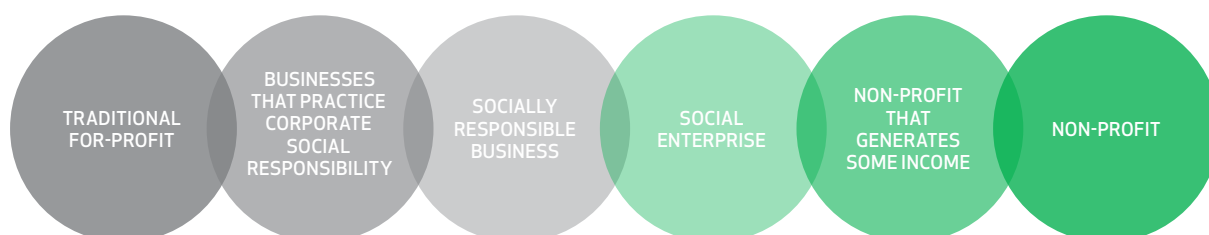
The ecosystem in New Zealand is also experiencing some of the growing pains that stem from changing perceptions of social business and form part of the impact investment expansion process. The recent criticism of Eat My Lunch is an example – essentially questioning the idea of social business itself. So as our understanding grows, ideas

around social enterprise are being discussed – and there is a marked rise in interest in impact investment. Some would argue that the concept of "deep impact" investing is being diluted as more and more interest in ESG, SRI and other ways of investing responsibly become more and more mainstream, it all helps raise awareness of investing with purpose – as the saying goes, all boats rise with the tide."



David Woods
Chairman
Impact Enterprise Fund

Impact investment spectrum



Demand increasing for responsible investment by managed funds

Many New Zealand boutique and mainstream funds now offer specific responsible investment (RI) products and approaches. RI involves making investment decisions based on financial return and social, environmental, ethical and governance criteria.

New Zealanders have among the highest uptakes of RI products in the world, the volume of investment having grown from \$79b in 2015 to \$183.4b by the end of 2017.¹

In Responsible Investment Association of Australasia's (RIAA) 2016 survey, 95% of respondents agreed that "it is of at least some importance that KiwiSaver funds consider environmental, social, governance and/or ethical factors". Mindful Money's 2018 survey findings were similar: 72% expected their investments to be managed responsibly and ethically, and 62% would move funds if they discovered their money was being invested in activities inconsistent with their values.

Demand is expected to increase, as younger investors seek to align their investments with their personal convictions and as RI offerings become more sophisticated. RI investment apps have been developed internationally that allow RI-focused investors to design portfolios that meet their specific values. If growth continues, analysts expect that RI will become the industry norm.

Exclusionary screening

Exclusionary screening excludes investments in entities:

- which engage in activities or products that cause significant harm to society or the environment or are unlawful or unethical, or
- whose operations are at risk of being curtailed, penalised, or made uneconomic, due to likely future legal changes or international agreements.

New Zealand funds commonly screen and exclude investments in companies involved in tobacco and weapons of war. The exclusion may be absolute or conditional – for example, prohibiting investment in entities (e.g. other funds) that derive above a prescribed percentage of income from excluded activities.

The Mindful Money 2018 Survey suggests that there is investor demand for investments that also screen out involvement in human and labour rights abuses, animal cruelty, nuclear power and adult entertainment.

“If growth continues, analysts expect that RI will become the industry norm.”

¹ RIAA, *Responsible Investment Benchmark Report 2018 New Zealand, and Responsible Investment Benchmark Report 2018 Australia*.

Demand increasing for responsible investment by managed funds (continued)

The Guardians of New Zealand Superannuation manage the New Zealand Superannuation Fund. They have identified exclusionary criteria and created a no-go list of companies, thereby creating a possible model for fund managers.

Niche products have been created using exclusionary screening such as Pathfinder Asset Management that is offering a *Vegan Invest* product that excludes investments in companies with animal welfare and testing issues.

Another example is Salt Funds Management listing an NZX-listed product investing in carbon credits issued under emissions trading schemes in New Zealand and globally.

Some managers are moving towards reducing involvement in fossil fuel production and green-house gas industries in response to public climate change awareness. But responsiveness to changing investor concerns can bring some challenges.

Excluding entire industries and asset classes may conflict with the need to ensure an appropriately diversified portfolio, and discerning between passing fads and long-term changes in investor outlooks can be difficult, and meeting investor expectations on returns (blacklisted companies are often consistently profitable).

Ongoing monitoring is necessary as investments may fall out of compliance with the exclusionary criteria, due to mergers and acquisitions or new lines of business. Managers need to receive timely information about their investments and might consider engaging specialist screening agencies or consulting regularly with RI organisations.

Exclusionary screening has its limitations. It is better for spotting lemons than picking winners, through enabling managers to avoid harmful investments. However, some consumers are seeking more – they want investments that not only avoid harm, but also have positive social, economic and environmental impacts.

ESG integration

Major New Zealand managers construct portfolios using both exclusionary screening and ESG integration. Through ESG integration, managers can seek to show that they are concerned with long-term sustainable growth rather than just short-term gains.

ESG integration involves systematically and explicitly considering ESG factors when making investment decisions. This can lead to better decisions: ESG factors may be material to an investment's long-term returns, and companies with good ESG ratings may have some distinct commercial advantages.

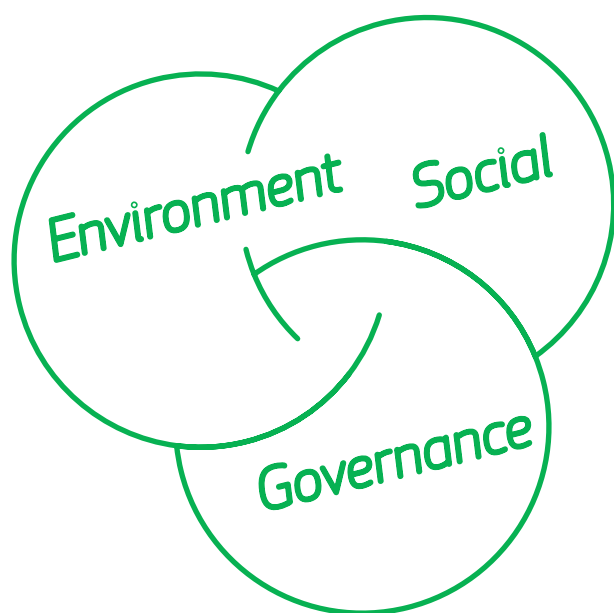
Comparative returns surveys show that ESG embedded investments generally deliver better – and more balanced – returns. RIAA found that both New Zealand and Australian RI funds outperformed relevant benchmarks across one, three, five and 10 years.² Global surveys have found similar results.

Significant resources are required for successful ESG integration. Extensive information must be gathered, new tools and methodologies applied, and extra time spent evaluating the findings. This may put pressure on fund managers to increase investor fees but indications are that investors are prepared to pay more for RI products.

“Comparative returns surveys show that ESG embedded investments generally deliver better – and more balanced – returns.”

² Responsible Investment Association of Australasia's (RIAA), Responsible Investment Benchmark Report 2018 New Zealand

Demand increasing for responsible investment by managed funds (continued)



RIAA's 2016 survey found that 42% of respondents stated a willingness to pay at least "a little more" for a fund that invests only in RIs.

These resource and fee implications may make ESG integration unsuitable for smaller funds but these funds will increasingly have ESG-vetted investments available to them as ESG integration becomes the norm amongst larger global investment vehicles. For example, exchange-traded funds (ETFs), such as BetaShares and UBS, now offer several ethical ETFs over global sharemarket indices.

"Responsible investment is now firmly entrenched in the mainstream global funds investment landscape and this makes commercial sense... The focus has now shifted to how the financial system itself contributes to sustainable development goals and the fight against climate change. In New Zealand, the launch of the Aotearoa Circle's Sustainable Finance Forum reflects this growing global effort to build sustainable economies."



Anne-Maree O'Connor
Head of Responsible Investment
Guardians of New Zealand Superannuation

Active ownership

Active ownership involves managers incorporating ESG issues into their ownership policies and practices, and seeking disclosure on ESG issues by the entities in which they invest. Active ownership strategies include managers considering ESG factors when deciding how to proxy vote, directly engaging with senior management and directors, and filing shareholder proposals and resolutions relating to ESG matters.

The Guardians of New Zealand have a significant active ownership programme (i.e. engagement and voting). Their investment managers also have ESG requirements in their mandates, with most of the active equity managers engaging on material ESG issues or on ESG reporting. Mercer Investments, for example, specifies active ownership as a key plank of its RI policy, along with exclusionary screening and ESG integration.

Over the last decade, global funds have sought to change how the entities they invest in operate to improve ESG performance. Areas of focus have been board representation, executive remuneration, environmental practices and labour relations. This approach has been used by managers whose target market is cause-motivated investors, but is being increasingly adopted by mainstream managers to protect and enhance their investments as part of their stewardship responsibilities.

Managers may be able to convince investors to invest in companies that they would not otherwise invest in, on the basis that through active ownership they can change the companies' practices for the better.

Demand increasing for responsible investment by managed funds (continued)

Other RI approaches

Other RI approaches include:

- **positive/best-in-class screening:** investing in those companies with superior ESG performance
- **norms-based screening:** excluding investments in companies that do not meet minimum standards of business practice based on international norms such as those defined by the United Nations
- **sustainability-themed investments:** selecting investments by reference to sustainability factors, for example, clean energy, green technology, sustainable agriculture and forestry, green property, or water technology, and
- **impact and community investing:** selecting investments that seek to address social or environmental problems, or are targeted at traditionally underserved individuals or communities, while also delivering financial returns.

These may be used together with, or as an alternative to, the main RI approaches. Smaller funds that are unable or unwilling to implement ESG integration may find them particularly useful.

Disclosure requirements

Managers may wish to apply different RI approaches to different product offerings, or to apply RI approaches to some but not all products. In such cases, consumers should be made aware of any differences, as this information will be relevant to RI-focused investors' product choices.

Inadequate implementation can open the manager to accusations of "greenwashing", and undermine trust in the manager's products. The Financial Markets Authority has indicated it will intervene where it considers that a fund has misled as to its RI label.

Currently, KiwiSaver providers are required to include a prescribed statement in their product disclosure statements on whether they take RI into account. For listed funds, NZX has issued a guidance note on the disclosure of ESG factors.

Greater disclosure requirements are likely in the future. New Zealand could follow international practice and require schemes to disclose how they manage ESG risks, and if not, why not.

In addition, the new regulation of financial advisers in the Financial Services Legislation Amendment Bill could require RI issues and their clients' RI values to be considered when giving investment advice.

New Zealand plays catch-up to world on ESG reporting

Reporting around ESG risks is now a global expectation. ESG reporting, which is seen as standard practice in other jurisdictions, is still relatively weak in New Zealand.

Latest information is that only 11 companies of the top 75 on the NZX by market capitalisation had reported on ESG matters. But we expect that number will grow.

The NZX Corporate Governance Code, updated in 2017, places a greater emphasis on non-financial disclosure, including material exposure to ESG risks. Compliance is recommended rather than compulsory – but the Code will influence stakeholder expectations, which should drive behavioural change.

The NZX recommendations are that issuers explain how they intend to manage ESG factors, that they report against a recognised international framework such as the Global Reporting Initiative and that they describe how the business is performing against its strategic objectives.

Transparency International New Zealand is also concurrently developing an assessment methodology, the “2018 New Zealand Financial Integrity System Assessment” (FISA), the first-ever review of the integrity systems of any country’s financial system. It covers New Zealand’s financial institutions along with their industry bodies, regulators, dispute resolution schemes and the payments and settlement system.

NZX’s guidance note on ESG reporting, released in 2017, identified three key elements for companies to manage sustainability and ethical behaviour.

Environmental criteria – how a company performs as a steward of the natural environment.

- **Social criteria** – how a company manages its relationships with stakeholders (i.e. employees, impact on the broader community, and/or suppliers).
- **Governance** – includes a company’s leadership, executive pay and shareholder rights, among other matters.

NZX’s guidance note also highlighted three key reasons companies should report on ESG matters, including:

- a changing global environment – a need to shift to a low-carbon economy, there is increasing business vulnerability to the effects of climate change, and generational change
- increasing investor interest – more investors are asking questions about corporate responsibility and care about sustainability when making investment choices, and
- the over-arching long-term strategic view of the business – to give investors a richer view into the long-term strategy of the company.

ESG reporting factors

Environmental	Social	Governance
<ul style="list-style-type: none"> • Biodiversity • Climate change • Pollution and resources • Water use 	<ul style="list-style-type: none"> • Labour standards • Human rights and community • Health and safety • Customer responsibility 	<ul style="list-style-type: none"> • Anti-corruption • Corporate governance • Risk management • Tax transparency

Source: Environmental, Social and Governance - NZX Guidance Note

Recent documents from the Financial Markets Authority, the Productivity Commission and the Institute of Directors have also referred to ESG risk management. The increased focus on impact investment should also carry over to an increase in ESG reporting generally, motivated in part by global investor demand.

Connecting action, impact and reward – social bonds

Social bonds are well established internationally and the National-led Government made a start on using them in New Zealand. The coalition Government seems less keen, but the investment which has been made in developing the model is still live, and the knowledge gained from the exercise is still available.

What are social bonds

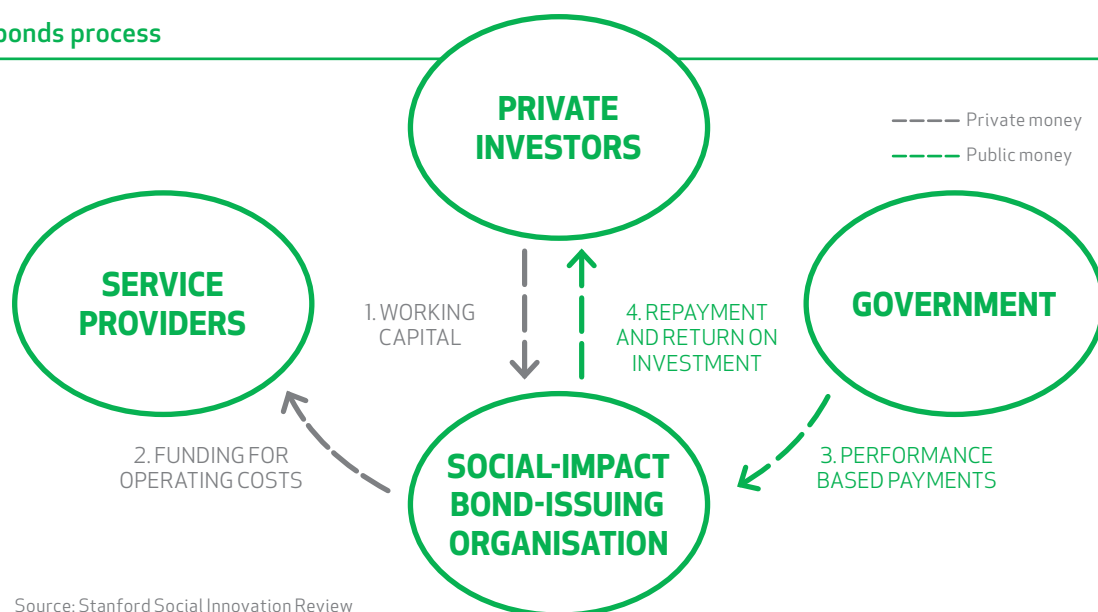
Social bonds, also known internationally as social impact bonds, are a means of introducing private sector, including philanthropic, investment to Non-Governmental Organisations (NGOs) for the provision of social service interventions targeted at specific social objectives (for example, reducing recidivism).

They are aimed at promoting innovation and service improvement for the benefit of those targeted by the intervention.

The role of the government is to pay the NGO for (and commensurate with) the achievement of pre-agreed social outcome improvements. Those payments are then applied by the NGO borrowers to repay their financiers, plus a return on that investment. This means that the performance risk is borne by the investors, not the government. Their returns (and even the return of the principal invested) are directly linked to the social outcomes that are achieved.

At its core, a social bond creates a strong nexus between action, impact and reward.

Social bonds process



Source: Stanford Social Innovation Review

Connecting action, impact and reward – social bonds *(continued)*

The New Zealand experience

Two pilot social bond transactions were conducted through the Ministry of Social Development under the previous government – one directed to reducing youth offending and the other to placing jobseekers diagnosed with mental health conditions into work.

The pilots attracted a diverse range of investors and involved a lengthy market-led co-development process. Measuring their success is some way off as the bonds have a scheduled term of six years and improved social outcomes can take time to materialise and may not do so in a linear way.

Despite the levels of investment made to get this far, the prospect of further uptake in the near-term faces challenges, for a range of reasons.

Some of these are ideologically driven – a reluctance to wind anything that looks like the profit motive into the delivery of social services. Yet the Government is looking at wellbeing, as investors want social impact. Social bonds are likely to follow the growth of green bonds.

Others are more associated with measurement issues – what the intervention has delivered and the actual level of benefit to Government (e.g. reduced welfare payments and other community and personal benefits that are less easily expressed in financial terms).

There is also the public sector cost comparator – could the government have funded the services directly and got the same results at a lower total cost?

The Social Investment Agency (SIA) and StatsNZ are developing methods and databases that are likely to build confidence and capability on these measures and attribution points but the socio-political impediments may remain.

Some observations

International wisdom would suggest that social bonds are best reserved for when the efficacy of the intervention is unproven, the benefits (including fiscal savings for government) could be high and there is no prospect of government funding – either because of budgetary constraints or because the service delivery method is experimental, making the government reluctant to put taxpayer funds at risk.

Consistent with the work of the SIA in developing evidence/data-driven improvements to enable more effective commissioning of outcomes-focused social services, the flavour of impact investment is informing the government's approach to its own spending priorities and business case model through the Living Standards Framework.

The desire for greater investment impact also underpins the kaupapa for the funding by Te Puni Kokiri of the three Whānau Ora commissioning agencies. These provide direct funding to NGOs, which are close to the aspirations and needs of the communities for which support is intended – whānau solutions designed by whānau.

A look into Te Ao Māori

Impact investment is integral to the Māori economy as iwi and hapū investment decision making has always been, and will continue to be, underpinned by cultural, social and environmental aspirations.



WHANAUNGATANGA

Balancing tensions

Iwi, hapū and Māori businesses are informed by the shared values of whanaungatanga (relationships), manaakitanga (looking after our people), kaitiakitanga (stewardship) and tikanga (appropriate action) to guide their investment strategies and how they use their pūtea (wealth) for ngā uri whakatipu.

There is a natural tension in balancing investments in cultural revival and wellbeing against the need to reinvest a proportion of the profits for iwi financial growth to support future generations. The expansion and normalisation of impact investing will provide a framework to help ease these tensions.

Housing

Last year, Ngāti Whātua Ōrākei built 30 affordable, medium density homes on the Ōrākei ridge-top under its Kāinga Tuatahi communal housing scheme, including underwriting mortgages to help whānau get into their own property.

Access to decent and affordable housing for iwi members is also a priority for Waikato-Tainui and Ngāti Porou, both of which are providing home ownership workshops to educate members on how to raise a deposit, source funds from Kiwisaver and engage in the property market.



KAITIAKITANGA

Post Settlement Governance Entities (PSGEs) aim to balance their commercial arm – which includes the management and administration of assets and the commercial activities of subsidiaries – with the needs of their people.

As the pūtea of iwi and hapū increases, Māori organisations will invest more in social enterprises of direct benefit to their members – leadership development, housing, savings schemes, and more.

MANAAKITANGA



A look into Te Ao Māori (continued)

Governance

As part of broader succession planning for iwi boards, Ngāti Awa and other iwi have instituted associate-director roles for members to gain governance experience without being exposed to the obligations and liabilities of a full director role.

Ngāi Tahu has also instituted a programme called Manawa Tītī, which seeks to harness the skills of formal and informal leaders through three two-day wānanga.

Savings schemes

Ngāti Whātua Ōrākei has launched a savings and investment scheme, Toi Tupu, which is available for all hapū members. Ngāi Tahu is looking to enhance its successful Whai Rawa savings programme by providing investor choice to their current conservative fund.

Both of these schemes will be expensive for their respective organisations – but long-term investment in their people, their financial security and financial literacy will reap rewards for these iwi and their members.

NGĀI TAHU HOLDINGS SEEDS RESPONSIBLE INVESTMENT FUND

Ngāi Tahu Holdings was the cornerstone investor in Pathfinders' Responsible Investment Fund, providing capital of \$48m. The fund will not invest in gambling, tobacco and weapons of war and scores companies on ESG factors.

Announcing the investment in 2017, Ngāi Tahu Holdings chief executive Mike Sang said the fund would allow them to manage their international equities exposure in a way that was consistent with their values.



Chapman Tripp's impact investment specialists

As New Zealand's leading full-service law firm, Chapman Tripp has deep insight across all forms of impact investment, including green bonds, social bonds, ethical funds management, social enterprises, and as part of strategic philanthropy.

Clients tell us they value our team's broad expertise and ability to work together to deliver greater efficiency and insight, and provide both commercially-focused and social solutions.

Our impact investment specialists – whose backgrounds include sustainable finance, philanthropy and trusts, funds, corporate governance, iwi and government – often act as intermediaries, connecting market leaders across the impact investment ecosystem, to generate social and environmental benefits alongside a financial return.

Debt capital markets and sustainable finance



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