**POLICY BRIEF * COVID19 ECONOMY GROUP**

# A sovereign social bond to fill a funding gap for the Covid-19 crisis response

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***In this paper we argue that the South African government could become one of a few sovereigns to issue a social bond to be used to fund the fight against the Covid-19 crisis and set out the detail for how an issuance could work. This could make a significant contribution to government's funding gap, raised at lower cost while diversifying the government's investment base to include ESG funds.***

## Introduction

The South African government faces significant funding requirements as it confronts the health crisis caused by the coronavirus pandemic, as well as the economic crisis arising from it. The crises require government to increase expenditure while revenue is simultaneously reduced due to lower tax and duty collections. The government's R500bn economic package includes several elements that will have to be funded out of the budget, however the SA Revenue Service has estimated that the revenue shortfall this year could be R285bn (SA Revenue Service, 2020). Estimates vary for the resulting budget deficit that will arise, but Intellidex currently estimates a deficit of 15.4% of GDP (Attard Montalto, 2020), meaning a total funding requirement of R806.7bn, assuming a drop in real growth of -10.6%. However, under a more negative growth assumption of -15%, the deficit could be -17.5% of GDP and a funding requirement of R863.3bn (Attard Montalto & Theobald, 2020). Before the crisis, the budget deficit was projected to be 6.8% this year (National Treasury, 2020).

This funding requirement will be met by both traditional and non-traditional sources. Government's bond issuance programme is expected to step up the amounts raised in weekly auctions by about 36%. This will already stretch the market, with government having lost its investment grade rating as the crisis was

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[1] This memo was prepared by Stuart Theobald and Peter Attard Montalto, drawing on input and comment from the Covid19 Economists Group, convened by Miriam Altman and including Andrew Donaldson, David Francis, Imraan Valodia, Alex van den Heever, Mzukisi Qobo, Tania Ajam and Wandile Sihlobo.

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The views expressed are those of the authors only, and any errors/omissions are theirs alone.

[2] This paper provides detailed discussion of the proposal, but a more technical earlier outline by Intellidex is available here which was based on an earlier concept paper available here.

mounting. Already rates on long-term debt have increased by about 300 basis points, touching 13% on 24 March 2020 before settling down to around 11.5% (Donaldson, 2020).

Additionally, government is turning to multilateral organisations such as the New Development Bank and the International Monetary Fund to access emergency funding that is free of conditionality. Such multilateral funding agencies have quickly developed resources to support countries, particularly emerging markets, at concessionary rates. However, even with these sources available, we foresee significant additional funding needs.

One source of funding that the South African Government could seek to access is the pool of impact or ESG (environment, social and governance) investors. While this is a wide field, a growing investment trend has been for investors to allocate a specific portfolio tranche to ESG themes. Such themes can include environmental degradation, corporate governance and social issues such as health and poverty. The particular mechanisms used for such investment can also vary widely as well as the types of businesses and other entities that receive such investment.

***In this paper we argue the South African government could become one of a few sovereigns to issue a social bond to be used to fund the fight against the Covid-19 crisis and set out the detail for how an issuance could work.*** Such a tool could be important, not just right now, but further into the future if the Covid-19 crisis goes through several waves in the coming years.

## Background on ESG investment

Environmental Social Governance (ESG) has grown internationally as investors have become increasingly motivated by a desire to invest in positive socioeconomic and environmental outcomes rather than financial objectives alone. The investment strategy is also sometimes called impact investing (though it can have a slightly different meaning in some contexts) which has been [defined by the Global Impact Investing Network]() as "the intention to generate social and environmental impact alongside a financial return" (Global Impact Investing Network, 2020).

Impact investors have a wide variety of objectives but can be broadly categorised in a range from "financial first" investors who prioritise financial returns to "impact first" investors who prioritise impact (Theobald, 2019).

*Figure 1: Range of investor strategies and mandates in ESG/Impact investing*

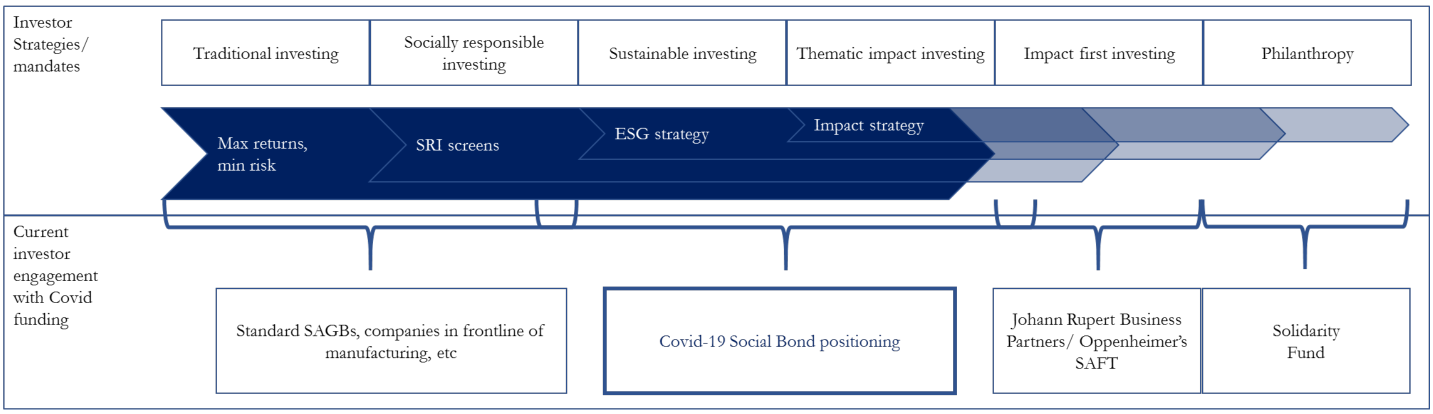



Figure 1 shows the range of investing mandates along this theme. Traditional investing focuses on financial and risk metrics alone. As social impact grows in importance, investment strategies can include more impact considerations, culminating with traditional philanthropy which can be thought of as an investment with 100% impact, 0% financial objective.

In the Covid-19 crisis, South Africa has been quick to introduce funding mechanisms at the philanthropy end of the scale (see figure 1). The Solidarity Fund was an early initiative that united private sector and government in raising funds to deal with the crisis. At the time of writing it had raised R2.72bn of a R4bn goal, with donors ranging from Mary Oppenheimer & Daughters (R1bn) to the Lottery South Africa (R50m) and 171,267 individuals (Solidarity Fund, 2020).

There have also been important initiatives we would classify as "impact first" investing. The Rupert family and Remgro pledged R1bn to Business Partners, which the family co-founded and in which it still holds a minority shareholding interest, to provide grants and loans to small businesses facing distress (Business Partners, 2020). The Oppenheimer Family also endowed the SA Future Trust with R1bn to provide interest-free loans to employees of small businesses and it is administered through South Africa's banks (South African Future Trust, 2020).

Traditional investors will also be funding the Covid-19 response through normal mechanisms, primarily SA government bonds. While any such receipts are co-mingled with all government funding in the National Revenue Fund, it is clear that substantial amounts of government spending will be directed to the Covid-19 response and funded out of its general budget. However, between these two extremes we believe there is an opportunity to tap into a new pool of ESG/impact investors whose mandates are able to fund the Covid-19 response. Such investors would desire social returns in addition to financial returns.

## Market interest

Both domestic and foreign investors have ESG mandates. A recent survey of South African pension funds found that 76% of respondents on a weighted basis considered "improving sustainability of my portfolio's investments" extremely important in the year ahead (Kruger & Theobald, Forthcoming). This was more important than "generating high risk-adjusted returns" (74%). Institutional interest was substantially enhanced following the publication of a guidance note by the Financial Services Conduct Authority in 2019 on the sustainability of investments and pension funds' investment policy statements (Financial Sector Conduct Authority, 2019). While many funds are still incorporating ESG investment strategies into their overall mandates, even 3% of the R4.5-trillion of investments in the pension fund industry would amount to R135bn.

Internationally, funds have followed a similar trend. More than eight in 10 individual investors in the United States now express interest in sustainable investing, with half actually doing so (Morgan Stanley Institute for Sustainable Investing, 2019), while Morningstar has shown that sustainability funds saw record inflows during 2019 (Hale, 2019).

In most large institutional funds, ESG investing is undertaken by a specific team that operates separately to the core investment decision makers. This team would usually have responsibility for a specific tranche in an overall fund, or for specific segregated funds that have an exclusively ESG focus. Similar approaches are also evolving in South Africa with institutional fund managers such as Futuregrowth and Stanlib now operating ESG-focused funds. Many general funds have also begun to incorporate ESG issues into their mandates, ranging from negative screening of investments that fail sustainability specifications through to backing high-impact, low-return investments that have high social outcomes. Indeed, we think that general asset managers increasingly have internal ESG principles that affect asset allocation at the margin. This trend will increase in the near future.

The Covid-19 crisis is clearly an issue that raises profound sustainability and social issues. It represents the greatest threat in a generation to the sustainability of lives and the economic order. There has, to our minds, never been a clearer issue for ESG investors to engage with.

## ESG market standards

A "social bond" is not just a name. The term refers to a specific class of instruments that investors use to achieve non-financial social objectives. These are subject to targets and governance frameworks like any other investment. These are voluntary, but market acceptance will be substantially greater if the bond can demonstrate that it complies with these, such that investors can be confident it meets their mandates and objectives.

While the typical investor in such an instrument might have high appetite for risk, would be willing to forgo financial returns and have relatively patient capital (i.e. long maturity), their expectations for impact returns are high. The only way for the South African government to secure "impact alpha" is to ensure that any such investment delivers measurable impact outcomes.

Investors looking for ESG exposures would usually comply with an international framework, such as the Global Impact Investment Network (GIIN) and it's IRIS+ standards; the United Nation's Principles for Responsible Investing (UNPRI); the Sustainability Accounting Standards Board (SASB) reporting standards; the Infrastructure Finance Corporation (IFC)'s Operating Principles for Impact Management and Global Sustainability Standards Board's Global Reporting Initiative (GRI). An instrument that is to achieve broad market acceptability should enable investors to comply with these.

For the issuer, in our view the key global standard is the Social Bond Principles of the International Capital Markets Association. These standards track the UNPRI (which in our experience is the most common standard used by investors) and are consistent with several other standards.

Guidelines have the following common features:

- Emphasis is on planning explicitly for adequately resourced monitoring and evaluation (M&E) and reporting teams and oversight committees;
- A policy framework to structure the bond (addressing chiefly how compliant projects will be identified, how expenditure will be monitored and how impact will be tracked, using existing measurement frameworks for social and green issues as a foundation, chiefly the Sustainable Development Goals or SDGs); and
- They engage an external evaluator to verify that bonds are compliant – eg an auditor, external consultant or rating agency (eg Moody's).

It is important to note that engaging with the spirit of these principles is the overriding concern and there is generally flexibility around exactly how compliance is achieved.

There are four areas that must be defined explicitly in a policy framework to structure the social investment:

1. **The use of proceeds.** Eligible expenditure categories must be defined, with categories tied to recognised social objectives such as those of the Sustainable Development Goals. For example, in the case of the Covid-19 bond:

| Theme of Impact | Alignment with SDG |
|---|---|
| Confronting the health challenge (preparation, treatment, testing) | • **Goal 3:** Good Health and Well-being |
| Protecting the economy (saving jobs, poverty relief, saving companies) | • **Goal 8:** Decent Work and Economic Growth<br>• **Goal 10:** Reduced Inequality<br>• **Goal 11:** Sustainable Cities and Communities |

2. **The process for evaluation and selection.** In the case of sovereign issuers, projects and procurement should be aligned with the eligible expenditure categories. For example, in a recent issue of a Green Bond by Nedbank, a special committee was put in place to identify potential projects for financing. For the Covid-19 Social Bond, a process that is clear, transparent and accountable must be determined to allocate the proceeds of the bond to particular expenditure items.
3. **Management of proceeds.** Clear policies must be formulated to manage the proceeds of the bond issue. Proceeds should "be credited to a sub-account, moved to a sub-portfolio or otherwise tracked by the issuer in an appropriate manner, and attested to by the issuer in a formal internal process…" (ICMA, 2018). A high level of transparency is encouraged and it is recommended that an auditor be used to verify internal tracking of proceeds and allocations of funds.
4. **Reporting.** Identify a project leader to gather data from different agencies and prepare reports; allocate and budget for personnel, IT systems, co-ordinate line ministries. Reporting should be done semi-annually.

Various levels of external review are recommended. These include:

1. **Consultant review.** A specialist consultant can help the issuer with the establishment of the social bond framework and then issue a second party review.
2. **Verification.** An issuer can have the social bond independently verified by a third party such as an auditor. Verification can focus on alignment with standards.
3. **Certification.** An issuer can have the social bond certified by third parties.
4. **Rating.** An issuer can have its social bond or associated framework rated by qualified third parties including rating agencies. An industry has emerged to inform investors on ESG credentials, including of sovereigns. Of note in the government bond space are Sustainalytics, RepRisk and Climate Bonds Initiative.

## Precedents

There are both domestic and international precedents which indicate the viability of a sovereign issuing a social bond. Social bonds are similar to green bonds in that both have set objectives for the use of proceeds and monitoring and reporting structures.

**Domestic**

In South Africa, several initiatives have been under way to develop ESG funding instruments. The Johannesburg Stock Exchange has developed listing rules for project bonds, which are debt instruments in which the proceeds are ringfenced to a particular project, and green bonds which finance sustainable investing in green projects. It is now working on expanding its green bond segment into a general sustainability segment (Johannesburg Stock Exchange, 2020). National Treasury recently released a technical paper detailing funding needs for climate change that outlines several market development opportunities to fund the flow of capital to climate change infrastructure (National Treasury, 2020).

Several green bonds have been issued, including two by cities – City of Johannesburg and City of Cape Town. Johannesburg was first, issuing a R1.5bn green bond to fund various green projects including 150 dual fuel buses and to convert 30 buses to biogas (C40 Cities, 2016). The Cape Town bond was issued during Cape Town's water crisis and raised R1bn, having received R4.3bn in bids, for water infrastructure in July 2017, with certification from the Climate Bonds Initiative (City of Cape Town, 2017). In the corporate space, two banks have issued green bonds, the first by Nedbank and the second by Standard Bank. The Nedbank issue raised R1.7bn after receiving bids of R5.5bn (3.2 times oversubscribed). It was listed on the JSE's Green Bond segment. Standard Bank listed its bond on the London Stock Exchange, raising $200m in a sale to a single financer: the International Finance Corporation (Wessels, 2020). The cities and bank bonds have done much to develop domestic institutional insight into the mechanisms of green bonds

There have also been two social impact bonds issued in South Africa. Social impact bonds are quite different to social bonds. The first was an early childhood development SIB launched by NGOs mothers2mothers, Volta Capital and the UCT GSB Bertha Centre for Social Innovation and Entrepreneurship, with R9m invested up front (Graduate School of Business, University of Cape Town, 2018). The second was a job creation bond called Bonds4Jobs arranged by Harambee Youth Accelerator with R75m invested up front (Blavatnik School of Government, 2018). These are in many respects at the vanguard of the social impact investment movement. Social impact bonds provide a return to investors only if the social objectives are achieved and in this, they are distinct from social bonds which provide a return agreed up front either way. This means investors have a powerful incentive to ensure that the social objectives are indeed achieved. In such bonds, investors are usually philanthropic or governments and the structure ensures that they are only paying for successful social outcomes – thus social impact bonds are also sometimes known as pay-for-performance bonds.

These experiences have helped to develop market insight into ESG generally and the mechanics of related instruments. Green bonds demonstrate clearly how debt instruments can be used to finance specific objectives, while social impact bonds demonstrate the tradeoff between returns and social outcomes (we consider below some investor views that ESG actually enhances returns). These experiences will assist the South African institutional investment market to quickly grasp the mechanics and objectives of a sovereign social bond.

**Offshore**

The global market has been actively developing ESG-related investment themes for several years. This has recently also entered the sovereign issuance space, with several governments now issuing green bonds and social bonds.

Since the Covid-19 outbreak, one sovereign, Guatemala, has issued a social bond (Berrospi, 2020), becoming the second sovereign social bond in the market following the first by Ecuador in January 2020 (Inter-American Development Bank, 2020).

Guatemala raised $1.2bn in total, with $550m in the 12-year social bond yielding 5.375% and $700m through a standard bond to 2050 yielding 6.125%. The two issues received $8bn in bids with 50bps cut off the guide yield. The bond will finance Covid-19 prevention, containment and mitigation efforts and/or seek to achieve positive social outcomes in Guatemala within the context of the pandemic or otherwise. The bonds are listed on the Luxembourg Stock Exchange. The prospectus of the social bond sets out a Use of Proceeds covenant for the social bond, listing eligible social investments. These include (Republic of Guatemala, 2020):

- Covid-19 response, including financing or refinancing health-related investments by education and health ministries, as well as certain other Covid-related investments under Guatemala's emergency law that have not already been financed.
- Food security that is threatened by Covid-19, including school meals, healthy eating for children and adolescents, programmes that prevent child mortality and chronic malnutrition, social and health-related investments targeting families living below the poverty line.
- Affordable basic infrastructure, including social-related investments targeting those below the poverty line.
- Access to essential services, including maternal and infant birth programmes and programmes to prevent and control sexually transmitted diseases.
- Socioeconomic advancement and empowerment investments including a free education service programme.

Covenants also set down the process for evaluation and selection of eligible investments (determined by the finance ministry), management of proceeds (transferred to the general account of the Republic, but with an amount equal to the proceeds allocated to eligible social investments), and reporting, including providing annual information to investors on the allocation of proceeds with categories, amounts and any additional information on eligible investments in respect of related impact or results. Reporting is specified to be in reference to the recommendations of the Social Bond Principles. An external expert in ESG research and analysis will be engaged to review projects to assess compliance with the "use of proceeds section" and their report will be published.

The use of proceeds has been aligned with the SBPs of the ICMA and with the SDGs, specifically 2 (zero hunger), 3 (good health & wellbeing) and 4 (quality education).

The Use of Proceeds covenant is fairly general in specifying compliant projects, with both already-budgeted and new projects eligible. Reporting is also limited: only amounts spent and allocations are required to be disclosed, with impact and results reported "if available". These terms set out objectives for investors to understand but provide fairly light specific obligations on the government.

Notably, however, the issue does not cover any economic interventions in the face of the crisis such as wage or corporate support measures.

Ecuador raised $400m with its pioneering social bond in January 2020 with an Inter-American Development Bank guarantee. Issuance supports mortgage loans and also complied with the SBPs of ICMA. This was the world's first sovereign social bond. It is intended to finance low-cost homes at a concessionary interest rate for 24,000 low- and medium-income families.

The government of Fiji launched a green bond in 2017 to finance USD50m green infrastructure with technical assistance from World Bank and IFC. It was heavily oversubscribed by domestic and international investors.

These international examples illustrate clear market demand for social bonds and a growing market understanding of the instruments and approach.

## Proposed Structure of a South African issue

Given the funding approach to the crisis adopted so far, we believe a special Covid-19 sovereign social bond should aim to unite South African and international investors in a joint effort to finance the battle against the disease in the country. For this reason, we advocate for three separate issues broadly under the banner of a Covid-19 sovereign social bond: domestic institutional; domestic retail; and offshore institutional. This wide ambit allows for a marketing campaign with strong political, business and civil society backing in which the funding is marketed in a spirit reminiscent of a "war bond". This would also align the general public with their institutional service providers. We provide some technical details of the different elements of the issue below.

**Domestic institutional**

The government's domestic medium-term note (DMTN) programme is the main domestic funding mechanism used for bond issuance through weekly auctions. The Covid-19 sovereign social bond would use the same mechanism and documentation, with a supplement to the prospectus to cover use of proceeds and reporting guidelines as outlined above.

Based on market feedback, we have also considered the use of a "step-up" coupon structure which could similarly be introduced through a prospectus supplement. This provides a dual coupon with a standard amount paid to bond holders, but with an additional spread paid on top of the coupon should the government fail to deliver on the social objectives set out for the bond. The step-up forms a financial penalty to the government should it simply use the proceeds of the bond as part of general government expenditure instead of the Covid-19 crisis.

The step-up reflects the distinction between a "normal" market yield and a social yield. In principle, a social bond should provide a "social return" in addition to the financial return. The step-up provides an indication to the market how this social return should be priced. If the bond proceeds are used for normal government activities rather than specifically for Covid-19, a normal commercial yield should apply, but if the social objectives are met, then a discount to the yield arises, with the difference indicating a value to the social return being generated.

It should be noted that the wider ESG field would not necessarily agree with this perspective. Indeed, some investment strategists argue that ESG-compliant investments *enhance* the financial returns. Our view, however, is that this perspective is gradually giving way to one that sees social returns as something of value that is distinct from the yield of the instrument and provides an alternative form of return that is "worth" something to the investor. The step-up structure makes this explicit by putting a notional value to the social outcomes of the bond. Should government not use the proceeds to achieve those social outcomes, it reverts to a "normal" market yield.

The step-up has advantages in guiding market pricing expectations but also serves as an information guarantee to the domestic institutional market that the proceeds of the issue will be used for the Covid-19 crisis. Our market soundings found some investor reluctance to accept government assurances alone on this front, especially given recent downgrades and memories of the past 10 years.

Such a structure has been used before in the South African context. For example the World Bank Eskom Renewables Support Project that has a carbon offset requirement with a battery project and wind farm. Should the offsets not be achieved, a step-up interest payment becomes due.

The yield that would be payable on the bond could, we anticipate, come in slightly below market prices for the instrument. This could be achieved only through a comprehensive marketing exercise that demonstrates the ESG value in the instrument, with the step-up as an underpin. With the five-year yield curve currently priced at 7.83%, we believe the book build should aim for a discount of 100bps. The size of the step-up can rest on various benchmarks – we have discussed the competing considerations in Theobald (2020).

Note that, while theoretically appealing, we do not believe a step-up would be appropriate for the offshore issuance of the social bond. We explain the reasoning in the offshore section below. A step-up onshore is appropriate given the different pools of investors and differing expectations.

We discuss potential tax advantages to the domestic retail issue below, but do not believe these should extend to the institutional issuance as most holdings are in tax-sheltered structures anyway such as pension funds.

**Domestic retail**

Over 170,000 individuals and entities in South Africa have made donations to the Solidarity Fund, indicating the degree of public support for the fight against the crisis. The fund has enabled the social solidarity that has arisen in the face of the crisis to find expression through financial support.

We believe that it is important to include a retail element to the Covid-19 sovereign social bond for three reasons:

1. It will promote solidarity of the broad public with the effort to raise funding for the crisis. The bond should be accessible and promoted directly to the public at large.
2. There is potentially a meaningful amount that can be raised from the public, including corporations. While many would not be able to sacrifice capital in the form of donations, they may be willing to (potentially) sacrifice some yield at low capital risk[3]. Companies can also be conspicuous in acquiring the bonds as form of social support in line with existing corporate social responsibility programmes.
3. A public marketing campaign would indirectly support institutional interest by demonstrating end-client support for investment into the institutional issue.

Government has an existing retail bond scheme, through which investors acquire bonds direct from government via a website or through post offices (Treasury, n.d.). To date government has raised R6bn through the programme, which was launched in 2004. Other countries have raised far more through retail bonds, for example Hungary, which raised $9.36bn (R173bn) between June and November last year (Than, 2019). The standard retail bond mechanism, however, is difficult to administer and does not lend itself to a quick launch at large scale.

As an alternative mechanism, a retail bond could be listed on the JSE's main board, along the lines of previous retail issues such as Jozi Bonds and Standard Bank's retail note (SBR003). The JSE can provide in-principle listing approval rapidly and listing fees are relatively low. While previous retail listed bonds have traded in denominations of R10,000, we think it best to trade in lower denomination of R1,000 to improve accessibility (which is also the denomination of existing RSA retail bonds).

The challenge for a JSE-listed instrument is that members of the public require a stockbroking account to access the instruments, which requires some administration and cost. However, there are several mechanisms that could be drawn on to ensure this is not a barrier. Standard Bank, Absa, and First National Bank provide a low-cost share investment service for clients. For example, Standard Bank offers the AutoShare Invest account at a brokerage fee of 0.15%. Other financial services providers, such as EasyEquities, offer mass retail accounts at brokerage of 0.25%. EasyEquities also provides fractional share trading, so the R1,000 denomination would not be the minimum trade size. Based on our conversations with some service providers, we believe there is strong goodwill among them to offer wide client bases a simple and low-cost mechanism to invest in the bonds that can be marketed strongly to clients. Intellidex estimates that the retail market in South Africa consists of around 500,000 active stockbroking account holders, but the wider banked retail market would be the potential market size.

We also believe that the retail issue should have a tax enhancement to compensate for a relatively lower yield. This will be particularly important to attract larger investments from high net worth individuals and companies. Two mechanisms could be used to provide a tax incentive:

1. Make the coupons paid on Covid-19 retail bonds tax free.
2. Provide a special window to buy the bonds in tax-free savings accounts without limit.

[3] We are conscious that this is not necessarily the case. Some interesting historic examples show that when a charitable action is instead motivated through payment, demand actually falls. This is thought to be because the donor derives utility from providing a gift that is higher than the utility from being paid. The seminal study is Titmuss (1970). In this case, it is important that the retail bond is still marketed as a charitable act rather than a profit maximising investment.

The first option could be extended to both companies and retail investors while the second would serve only retail investors. Effectively, a tax break on the interest paid on retail bonds compensates for a lower yield on the bonds. It also parallels tax breaks given to Solidarity Fund contributions. Tax-free savings accounts are currently the main incentive mechanism to drive improved savings behaviour in South Africa. Giving the bonds the special status to be bought in such accounts may help contribute to widening savings behaviour. Currently such accounts are subject to contribution limits of R33,000 per year and R500,000 in a lifetime. By allowing no limit on purchases of retail Covid-19 bonds, investors will be able to substantially increase the size of their savings within the tax shelter. When the capital is redeemed, the proceeds would be eligible to stay within the tax free accounts to be diversified into other instruments.

Investors would need to hold to maturity should they choose to use such a structure, or sell at a penalty. However, this may, on a lifetime view, lead to a larger tax leakage than simply providing the coupon on the bonds as tax free as in option 1.

We believe the retail issue could be marketed at a yield of the repo rate. As of 5 May 2020, the repo rate was 4.25%, whereas five-year RSA retail bonds were marketed at 10%. With a tax incentive factored in, the effective interest rate is 6.1625% for taxpayers in the highest bracket. We think this would remain attractive, combined with the social return of supporting the crisis response.

A step-up coupon would not be appropriate in the retail issue as we don't believe it would affect individuals' perception of social return risks.

**Offshore issuance**

The government currently has an offshore issuance programme through which it issues USD-denominated Eurobonds that are listed on the Luxembourg Stock Exchange. We believe the same programme could be used to issue Covid-19 sovereign social bonds to an international investor market with minimal additional documentation. The reporting and use of proceeds restrictions to comply with the SBPs of the ICMA can be contained in an addendum to the prospectus, similar to the domestic issue.

The ESG investment market globally is substantially larger than the onshore market and ranges from large institutional fund management houses through to sovereign wealth funds, pension funds and development funders. The social bond precedents discussed above were many times oversubscribed and subject to substantial investor interest.

However, other countries will perceive the same opportunity, so we anticipate some level of market saturation will arise. We have discussed the opportunity with several large global institutions and they confirm both appetite and availability now, with previous subscription levels having guided the market into perceiving some level of scarcity of such assets now.

An important consideration for the offshore issuance is how hard currency proceeds will be managed. South Africa has wisely avoided currency risks arising in its debt portfolio by ensuring hard currency funding raised is used for hard currency liabilities, such as its global diplomatic force. Currency risks will arise anyway in borrowing from the IMF and New Development Bank which will have to managed. The Covid-19 battle will require considerable hard currency expenditure, for example on testing kits. While South Africa's public spending systems do not easily allow for offshore proceeds to be directly connected to offshore expenditure, some mechanism would be needed to create this link to minimise currency mismatches on the government balance sheet.

**Credit enhancement**

One potentially attractive feature for offshore investors would some form of credit enhancement on the offshore bond (local credit enhancement might be a further consideration, though we do not think onshore asset managers will be concerned about a sovereign credit enhancement at this stage). This would lessen investor risk in facing the South African government as the obligor on the debt. Credit enhancement could be in the form of a World Bank guarantee on some portion of the principle or some similar structure.

A precedent for this sort is Ghana's $1bn 2015 issue, which had 40% guarantee from the International Development Association, a World Bank group member (World Bank Group, 2018). This structure enabled Ghana to gain a two-notch rating uplift from two international rating agencies and gain access to the international bond market, which it had previously not been able to.

The market effects of the guarantee, however, are not straightforward. The following points must be kept in mind:

- South Africa already has access to the market in having an active offshore (GMTN) programme. Because of this, some market sounding feedback was that the guarantee would have little impact on pricing levels.
- Other institutions said the guarantee could be tied to the social obligations of the government and in that way provide a pricing signaling mechanism to ensure the issue prices below the curve. The guarantee could specifically be attached to the social aspects of the bond. This would depend on the World Bank's own innovations and offerings.
- The guarantee can interfere with the "emerging markets-ness" of the bond. This may make it difficult for specific EM-mandated funds to invest in it. This is clearly the case if the guarantee were 100% of the capital, in which case the credit risk would be AAA and clearly not consistent with an EM mandate.

A guarantee may also not be in the interests of the South African government if it detracts from other exposures the World Bank may take to South Africa, including direct funding. The guarantee would contribute to South Africa exposure ceilings. South Africa will at the same time be looking to access direct funding from the World Bank.

There is perhaps scope for creative credit enhancement techniques from the World Bank and potentially other institutions that could be used, but we await any such innovations to be proposed by them in response to the Covid-19 crisis. While we could easily be persuaded otherwise, it does not appear that guarantees as they stand would be in the interests of South Africa or support the offshore issuance substantively enough. There is also a cost to pay by the government for such support (a small fee generally of around 50bp per year).

**Index inclusion**

A key factor to consider for international issuance is whether the bond is eligible for key bond indices. Bonds that are included are acquired by funds that benchmark or track against the indices. The JP Morgan emerging markets bond index (EMBI) is the most widely referenced, alongside specific indices such as the local government bond emerging markets index (GBI-EM). There are also several ESG indices which upweight constituents of base indices according to their ESG enhancements.

The social bond would be eligible for the EMBI and GBI-EM as a vanilla issue, but guarantee and step-ups would complicate this. JP Morgan does not currently include any bonds with step-ups as they cannot model the cashflows as required by index rules. Currently, bonds with guarantees are also not included as they conflict with EM criteria, though JP Morgan says it is reviewing this, partly due to the Covid-19 crisis and the expected increase in credit-enhanced instruments issued by EMs in response to this crisis (personal communication).

Index considerations are therefore a further reason not to include a step-up coupon. Credit enhancement need not be seen this way as index approaches are likely to adapt to accommodate it.

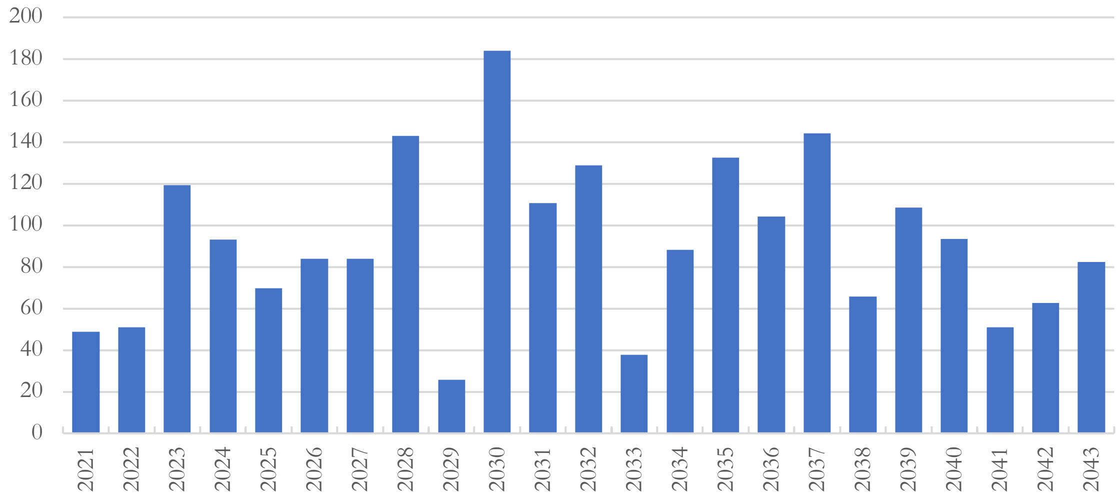
## Coupon and maturity

In our view, the crisis focus of the bond dictates that it should be shorter term. Even though the legacy of the crisis will be with us for some time, the immediate battle is likely to take place over the next 12-24 months.

**Domestic**

The main consideration for the maturity is the rollover risk, which is the risk of settling a bond's principal and not having access to alternative funding. For that reason, the government spreads maturities out over time so that there is no major concentration of rollover risk at any one point. The maturities of the existing portfolio are shown in Figure 2 below. As can be seen, 2025 provides some room for additional maturities with R70bn currently scheduled compared to R93bn the year before. A five-year maturity is therefore optimal in our view. We should also consider that any repayment of IMF facilities will occur in quarterly payments between three and five years from drawdown (expected to happen early in Q3 this year).

*Figure 3: Principal redemption amounts (Rbn) RSA government bonds*




In respect of coupons, Treasury has been intending to increase the share of variable rate instruments in its portfolio. Variable rate coupons pay by reference to some market interest rate, such as Jibar (the interbank rate set locally) or Libor (the international equivalent). Variable rate notes reduce government's interest rate risk as the cost of the finance increases and falls in line with market rates.

A variable rate coupon aligns the interest rate risk with the overall Covid-19 crisis response. Global economic measures have already shown strong monetary stimulus, with the aim of reducing market rates. A variable rate therefore achieves a degree of risk matching – that the worse and more enduring the crisis, the lower the cost of debt. A faster-than-expected recovery will see the cost of debt increase, but at the same time, it will be needed less. The South African yield curve is also sharply upward sloping, with spot yields just above 3% but five-year yields at 7.8%. A floating rate note therefore implies lower debt service costs in the short term.

The question then is which reference rate to use for the variable coupon. Domestically, our view is that the repo rate should apply. This is the main monetary policy instrument of the SARB so the risk matching is most closely achieved through this instrument. Some margin over repo could be used if the bond prices at a level above it, though currently spot yields are below repo.

**Offshore**

There is minimal issuance of floating rate notes (FRNs) offshore, particularly in the past decade. It is far more common for fixed rate issues, which are benchmarked against Libor. Currently, only Israel has an FRN in issue that trades in any volume, but it is small. South African (fixed coupon) USD Eurobonds trade at a margin above Libor and an approximate RSA Libor curve exists with current spot yields at around 435bp over Libor for three-year paper, rising to 540bp over for five-year paper and to 635bp for 10-year paper.

As we discuss below, the yield that the bonds could achieve in the market would aim to be below the "normal" curve prices for SA bonds. This would be less the case offshore where the bond will be priced closer to the curve.

We think the five-year tenure would be appropriate for both onshore and offshore issuance, but onshore should use a floating rate structure while offshore should be fixed rate, based on a spread over Libor.

## Yield

As pointed out above, we believe that the social benefits of the bond should be "priced" in the form of a discount on yield to the normal commercial yield. However, different factors speak to the yield that can be expected in the offshore and onshore markets.

Onshore, the social function of the bond and the economics faced by investors are different to offshore. Onshore institutional investors are widely exposed to the South African economy and therefore have a strong incentive to support broad initiatives that aim to limit the economic harm of the crisis and accelerate the recovery. The social bond's objective of limiting economic damage provides indirect economic benefits to any widely exposed investor.

The South African political economy also supports strong engagement by domestic institutional investors. Pension fund members and other ultimate beneficiaries are widely exposed to the crisis and derive a benefit from efforts to limit its impact and therefore it is the fiduciary responsibility of fund managers to support efforts to limit the effects of the crisis. Certain political actors have argued, prior to the crisis, that domestic investors should be compelled to invest in the economy through prescribed assets, which we have argued is a harmful idea (Theobald, 2019). Support for public initiatives such as a Covid-19 sovereign social bond would bolster the case that prescription is unnecessary.

Institutional investors have also said that ESG considerations are growing in importance (see above) and a social bond represents a clear mechanism for ESG factors to be improved in the portfolio. The Financial Serves Conduct Authority ESG guidance note (see above) counsels funds to provide members with detail on the role of ESG in the investment policy. It would be a strong benefit to the marketing of the bond if the FSCA were to comment on the suitability of the bond to fit an ESG mandate.

The step-up coupon provides further support to a social discount. We have discussed some of the technical considerations for how the coupon should work elsewhere (Theobald, 2020), but the simplest in our minds is a set spread over the floating rate base, perhaps in the region of 100bps. On this basis, the bond could be marketed with the intention of achieving a discount of a similar margin off existing yields. Treasury bills are currently issued at 4.23% to 4.48%, which can form the step-up coupon level.

The domestic retail yield would consist of a base rate and the enhancement achieved through the tax benefit. We believe the bond could be issued at repo (currently 4.25%), implying an after tax yield for highest margin tax payers of 6.26%.

The offshore yield faces different considerations. The externalities of wider benefit to the South African economy do not apply given far wider global exposures, though some investors will have RSA bond exposure. There is a larger pool of ESG funding, but any issue is unlikely to be able to rely on this source alone. Issues would need to be appealing to general emerging market debt funds that do not have an ESG mandate.

In our market soundings, we have come to the view that the market would accept a small discount to the yield curve to reflect the social bond nature of the issue. This would be achieved through greater market interest driven by ESG funds as well as an implicit level of support for ESG through the sustainability consequences for normal bond funds. Based on market indications, we think a discount of 10 to 50bps can be achieved, depending in part on the detail of the use of proceeds (discussed below).

## Potential proceeds and use of proceeds

The amount raised depends on the success of book building, the yields accepted and the strength of the marketing campaign.

Offshore, Guatemala's issue raised $500m (R9.3bn) and was 15 times oversubscribed. Market appetite for RSA exposure might be relatively weaker given the relative scarcity of Guatemala debt and South Africa's worse underlying credit indicators. However, South African paper is much more widely held in existing portfolios and therefore there is a much wider level of understanding and experience with South African instruments.

Onshore, institutions are currently faced with considerable market volatility and, in some cases, client withdrawals to provide emergency liquidity. These will reduce domestic demand. On the other hand, the urgency and need for funding would be widely recognised, and this was clear in our market sounding. The same ESG factors discussed above will apply to overall market demand and volumes that can be issued.

Our view is that an issuance should be ambitious and ground-breaking. The domestic asset management sector has R4.15trn of assets and the insurance sector has R2.7trn (Theobald, 2020). A 1% market share of these assets is R68.5bn.

The domestic retail issue could also attract reasonable volumes. The issue could draw on general public support as well as support from large companies and high net worth individuals. As we discuss below, a marketing campaign that draws support from public figures including the president, civil society and business leaders could galvanise public support.

A concerted campaign across all three elements, we believe, should be ambitious in targeting R100bn as the amount to be raised. This could be divided approximate as R40bn onshore institutional; R10bn onshore retail; R50bn offshore institutional. Government may well choose to target a lesser amount up front but leave the flexibility to increase issuance if market demand allows.

A key issue raised during market soundings was whether the proceeds would merely displace "normal" government expenditure. The implication is that government would spend the same money anyway, so the issuance doesn't make a difference in the spending amounts or purposes of government. The feedback was that the market would be more easily persuaded about the ESG value of the issue if it supported spending that would not happen without it.

There is no easy answer to such concerns. We believe that a specific Covid-19 issue would enable, to some extent, spending that would not happen without it. This may be more the case in economic interventions. While the proceeds would be co-mingled with the general revenue fund, government would need to report on the use of the proceeds to meet specified objectives (as we discuss in the next section). This would create broad political and bureaucratic flexibility to call for greater spending in the Covid-19 fight.

The use of proceeds would be governed by the SBPs set out in the prospectus. We believe there should be two main spending areas (we flesh these out in more detail in Theobald, 2020):

1. Medical costs
   - Preventing illness: reducing direct and indirect costs. This would include purchase of PPE, diagnostic equipment including tests and quarantine facilities.
   - Support the management of illness. This would include temporary hospitals and facilities in underserved areas, variable staff to increase capacity at existing facilities and funding critical care clinical equipment such as ventilators and pulse oximeters.
2. Economic costs
   - Wage support, including payroll subsidies.
   - Poverty relief, including social grants to those affected by the crisis.
   - Business support, including concessionary loans through government guarantee schemes.

Spending would be monitored by an independent monitoring and evaluation agent such as a global audit firm, as we discuss under governance, below.

## Governance

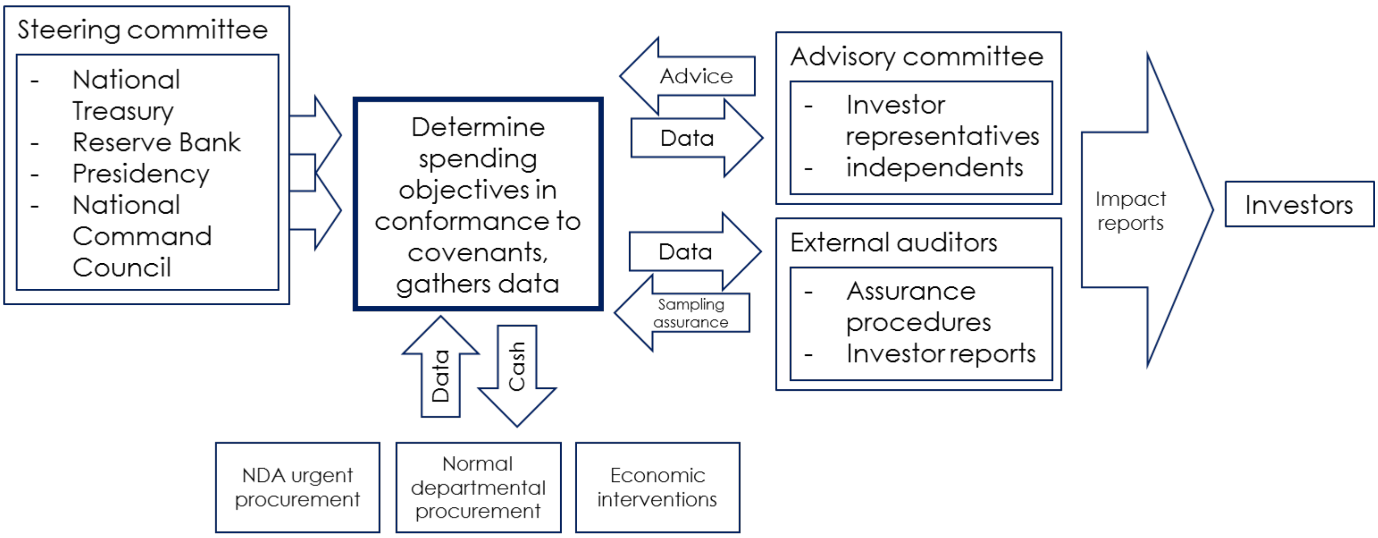
A key difference between a social bond and a normal government bond is the data and reporting requirements. Alongside normal financial reporting, a social bond requires reporting on social outcomes. This requirement would be an adjustment for normal government spending processes as amounts would have to be monitored with information captured on procurement and then the use and outcomes of the services and goods procured. While some bonds in the impact field provide detailed impact theses and metrics, we do not believe that a social bond of this nature would require too much detail. For example, Guatemala's issuance limited itself to reporting only amounts spent and allocations, with impact and results reported "if available". However, it would be in the interests of South Africa to build credibility in impact measurement and reporting to ensure it reports thoroughly.

Measuring impact is a matter of extensive debate worldwide. The general view is that one needs an impact thesis, an account of how spending does have an impact; metrics to determine whether that impact has been achieved; and a budget that can be monitored. This framework for reporting is desirable, though the government need not commit itself to delivering it, as precedents show.

We have considered whether the proceeds of the bond should be ringfenced. Our view, based on legal feedback, is that the Public Finance Management Act creates too big an obstacle to ringfencing, given that it requires any proceeds that encumbers the state to be paid into the general revenue fund. However, what matters is the evaluation and reporting of spending, rather than the co-mingling of proceeds.

To ensure appropriate spending and reporting, a governance structure along the lines of that depicted in Figure 4 is appropriate. All spending objectives should be set by a steering committee working alongside the National Command Council (though it should ensure it endures beyond the cessation of a state of disaster). Procurement can take place through emergency stipulations in line with regulations set under the National Disaster Act, as well as through normal departmental procurement. The economic interventions can be funded from the proceeds through National Treasury.

*Figure 5: Overview of governance of bond proceeds*




The critical part of this framework is the flow of data to enable reporting. Social outcomes need to be tracked and reports drawn up for investors. This means a reporting framework would have to be developed to ensure that frontline staff using, for example, equipment purchased, capture data on the outcomes of the use of that equipment (e.g. number of people treated with a ventilator and their health outcomes). Reports and data would then be subject to assurance procedures by an external audit firm who would compose a report to end investors.

Importantly, the data and assurance would be the basis for triggering the step-up coupon on the domestic bond. If social outcomes are not delivered to pre-agreed levels, the government would then have six months' notice to cure the "social default", failing which a single semi-annual coupon would be for the higher amount.

The specification of the social hurdles can be in simple monetary terms, in amounts of spending on objectives specified in the use of proceeds. This can be on straight-line basis through the five-year term of the bond. The social hurdles to be met are, in our view, easily attainable. The penalty coupon is an information signal and unlikely to be triggered.

A further governance element is an advisory committee. This would have access to data and be able to advise government on monitoring and evaluation. The committee would also issue a report to investors alongside the report made by independent auditors. Such a structure has been used when institutional investors such as pension funds make direct investments in property assets. Such committee members become insiders so would not be able to trade the instruments, but many funds would acquire the assets with no intention to trade. The purpose of the committee is to provide some direct support and guidance on the use of proceeds and to report to the balance of investors. Its existence is an information signal to investors that similar investors have direct access to information and play an oversight role.

## Cost considerations

The structure we have outlined above has been conceived with cost in mind. The issuance would use the normal domestic and offshore issuance programmes, with only minimal additional documentation to cover compliance with the SBPs. The onshore retail issuance would require the listing of a new instrument, but simple documentation would be sufficient to comply with the JSE's rules as we understand them, with financial reports in line with those that would be made in terms of existing programmes.

The social bond nature requires external support which will incur some cost. Third parties will be needed to review the structure pre-issue to confirm compliance with the SBPs. This can be done by specialist consultants or a ratings agency. Once issued, an assurance role will be required to be performed by a third party such as an audit firm.

The book build will need support from mandated investment banks.

In our experience in developing this concept, we have encountered a great deal of goodwill from market participants. We believe the nature of the instrument means that government will be able to draw on this goodwill to reduce costs in many respects of mounting the issuance.

We have not estimated in terms of basis points what the costs would amount to for the issuance. However, we think it is clear that the volumes and discount to normal issuance would more than compensate for the costs.

## Marketing

Marketing of the bond through all three of its elements will be critical to its success. The gravity of the situation has already galvanized the public and social partners into unprecedented action. The Covid-19 sovereign social bond must reflect the same spirit.

We think that key to the success will be:

- Explicit endorsement by the president and a call for the public and institutions to invest in the bonds.
- Support from the country's banks to offer clients low-cost and simple access to the bond via online banking platforms, usually through existing low-cost share trading accounts.
- Support from influential political figures in unison with unions, wider civil society and other influential figures for investing in the bond.
- Support from media organisations.

To reach the goals we have discussed in this paper, the bond would need to draw on an unprecedented public support for the fight against the disease.

For the onshore institutional bookbuild, the retail marketing effort would help to align institutions with their ultimate retail clients. While institutional mandates will dictate what capacity they have to support the issue, what will be important is a sense of being aligned with clients as well as the wider benefit from increasing the probability that the country survives the crisis less damaged than otherwise.

Onshore bookbuild will require specific efforts by investment banks to reach out to ESG specialists within pension funds, insurers, pension fund advisors and others. An exceptional effort is required outside of the normal weekly auctions process.

Offshore, a bookbuild will also be required. This can be managed effectively through various ESG forums such as the United Nations' Global Investors for Sustainable Development Alliance, which has access to the most active ESG investors globally. Certain investment banks have specialist ESG teams which can access the largest global ESG investors as well as traditional emerging market bond investors.

## Conclusion

The Covid-19 crisis requires innovation across both health and economic fronts. The need for innovative approaches to financing the government's response to the crisis is clear.

The field of ESG instrument design has been highly active in the past few years. It has served an evolving marketplace that has reflected changing ideas about the social function that investors play. While financial returns will always be key, there is increasing recognition in mainstream investing circles that social outcomes and sustainability are important. There are varying views on how these should relate to the core investment principles of risk and return management, but it has created an investing marketplace that can be far more responsive to the funding needs created by the crisis than ever before.

The South African government has long commanded global respect for its bond issuance and financial transparency. This positions it well to become a pioneer in a sovereign social bond issuance. We hope this paper stimulates thinking along these lines.

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