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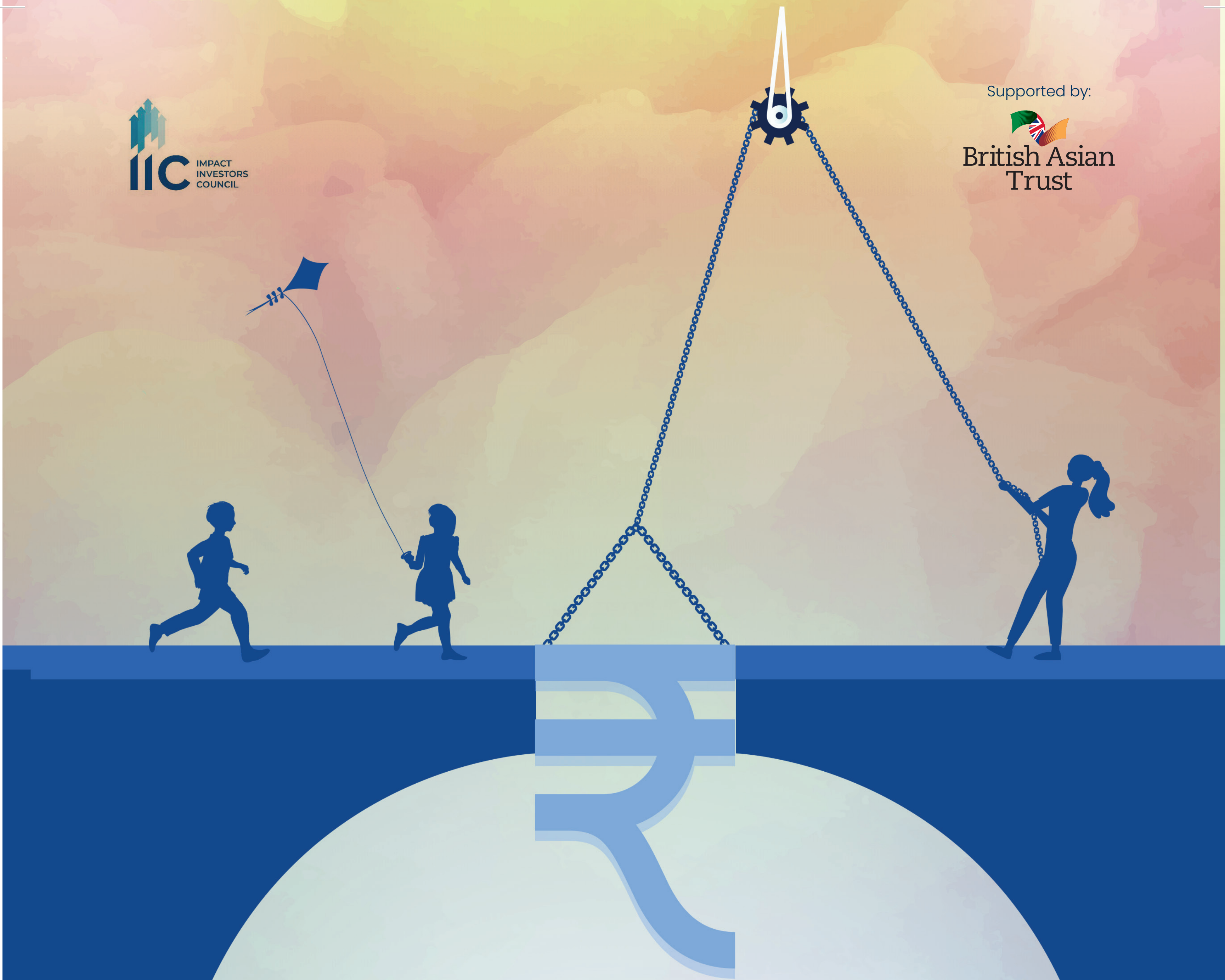

India Impact Investing Handbook

A multidimensional view on enabling social impact

Impact Investing as an emerging asset class and the regulatory response in India

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Impact investing has gained focus in recent times driven by increasing attention to sustainability factors in the world at large. The role of investors in the impact ecosystem is being viewed beyond simply allocating capital, as many investors are now interested in assessing the impact and sustainability outcomes of their investments with intentionality. While the primary objective for an investment fund is to generate a financial return and minimise risk for its beneficiaries, the defining feature of impact investing is to pursue additional, or even distinct, sustainability impact goals. In view of these dual objectives, there is merit in the proposition of impact investing as a separate asset class as it would encourage different investors to increase their asset allocation to social and environmental impact goals. While certain recent regulatory amendments were introduced to target increasing the flow of impact capital, further legal intervention is needed from time to time to keep up with the momentum of the impact sector.

1 AIF – Social Impact Funds

Alternate Investment Funds (AIFs) are a significant source of private capital for impact sectors from domestic and foreign investors. The SEBI AIF Regulations first introduced Social Venture Funds (SVFs) as a Category-I AIF that could invest primarily in securities of social ventures that satisfied its own criteria for social performance and provided restricted or muted returns to the investors. Only trusts, societies and not-for profit companies registered under Section 8 of Companies Act 2013 were eligible as social ventures that could receive investment from SVFs. The regulations overlooked for-profit social enterprises as viable avenues of investment by SVFs and carried a negative connotation with the use of the phrase “restricted or muted returns” that failed to encapsulate the value of social returns for impact investors.

The recent SEBI (Alternative Investment Funds) (Amendment) Regulations of July 2022 have re-christened the term SVFs to Social Impact Funds (SIFs) and relaxed certain investment conditions to attract a deeper pool of capital from different classes of investors for a wider range of impact areas.

- SIFs are now permitted to invest in social ventures as well as social enterprises. The term “social enterprises” is defined under the SEBI Issue of Capital and Disclosure Requirements) Regulations, to include both not-for-profit organizations and companies set up as for-profit social enterprises. The list of activities that social enterprises can be engaged in to establish a primacy of social intent has been expanded to include a wider range of sustainable impact goals and associated support activities such as technology, incubation, training, and capacity building.

- The amended regulations omit the phrase “restricted or muted returns” to give social impact a more holistic meaning and put social returns on the same footing as financial returns.

- SVFs could earlier raise capital with a minimum investment amount of INR 1 crore, which impeded investments by retail investors who wanted to contribute to social impact. Following the amendments, SIFs can receive a minimum investment of INR 2 lakhs from an individual investor. Similarly, SVFs required a minimum investment corpus of INR 20 crores to invest in social ventures. The amended regulations permit SIFs with a corpus amount of INR 5 crores to invest in both profit and not-for profit entities. Earlier, SVFs could receive grants of a minimum INR 25 lakhs. This threshold has been lowered to INR 10 lakhs thereby expanding the pool of grant-makers who can contribute to SIFs.

While the amended regulations are a step in the right direction, there are other regulatory interventions that could be considered in the interests of increasing capital flows for impact projects through SIFs. For instance, the diversification norms for Category I and II AIFs do not permit more than 25% of the investable corpus to be invested in a single investee company, either directly or indirectly, other than accredited investors in large value funds. This may act as a deterrent in using SIFs in structuring impact projects, as the funding to the social enterprise would necessarily have to be pooled in from multiple investors. Given the minimum corpus requirement for SIFs has been reduced to INR 5 crores, they should be given flexibility to pool all the investible funds into building a single impact project at a time.

2 Diversifying the investor pool

The regulatory framework for other domestic investors such as mutual funds, insurance companies, pension funds and banks can be examined for potential relaxations to enable greater investments in SIFs and social enterprises.

For instance, insurance companies are permitted to invest in infrastructure funds, and social venture funds of AIF-I category, but the exposure cannot exceed 10% in case of social ventures and 20% in case of infrastructure funds.

Domestic pension schemes are permitted to invest in AIFs but with a ceiling of 5% of their corpus and only in those AIFs that have a minimum corpus of INR 100 crores and minimum AA rating. On the other hand, social impact funds may have a much smaller size with a minimum corpus of INR 5 crores. The exposure of a pension fund to a single AIF cannot exceed 10% of the AIF size. These conditions together limit viable investment opportunities in smaller scale impact projects.

Mutual funds may not be adequately incentivised to invest in social impact funds due to restrictions on the marketability of privately placed AIF units.

Banks require Reserve Bank of India (RBI) approval to invest more than 10% of the paid-up capital or unit capital of an AIF (category-I or category- II). RBI's prudential regulations classify investments in unquoted securities and units of AIFs in a higher risk category to which allocation of investments by banks is restricted.

The Reserve Bank of India (Priority Sector Lending – Targets and Classification) Directions, 2020 (PSL Directions) provides that minimum 40% of the adjusted net bank credit shall be provided in priority sectors which includes impact areas such as education, housing, weaker sections, building 'social infrastructure' such as schools, healthcare and sanitation facilities, and renewable energy. However, while the maximum loans that can be granted per borrower for renewable energy projects is INR 30 crores, the cap for allocation to social infrastructure is much lower between INR 5 to 10 crores per borrower. Further, the priority sectors currently identified in the PSL Directive do not include pressing impact areas like climate change adaptation, pollution control/prevention or circular economy projects.

Banks are the leading source of capital in the Indian economy. To support India's transition to a more sustainable economy, the ambit of PSL Directions should be expanded to other impact areas and the cap on loan amounts under the scheme could be relaxed. The possibility of granting concessional priority sector loans through reduction in interest rates could also be explored.

Corporate funds can also be a useful source for impact finance. One of the low hanging fruits that could be targeted for greater impact is the mandatory corporate social responsibility (CSR) spending budget of companies. Currently, CSR money can be channelled to a social impact fund structured as a trust, society, or Section 8 company if its purpose and activities fall within the list of recognised CSR activities. However, many corporates comply with their CSR obligations simply through grants to non-profit organisations without additionality or impact measurement. There is great potential to scale up impact by utilising CSR funds in pooling structures for impact projects, or as risk or first loss capital for incubation stages of impact projects in both for-profit and non-profit scenarios. CSR capital can help catalyze larger institutional investors who may expect outcome-based returns upon the project's maturity.

3 Social Stock Exchange

Following a series of consultation papers, SEBI introduced the regulatory framework for a Social Stock Exchange in India. The regulations permit a non-profit organisation to register itself and raise funds on the Social Stock Exchange by issuing innovative instruments such as fixed tenure Zero Coupon Zero Principal Instruments, loans and donations for a specific eligible project or activity.

Separately, one of the conditions that a social enterprise must satisfy is that it shall target underserved or less privileged population segments or regions recording lower performance in the development priorities of central or state governments. This condition needs to be clarified as it could potentially restrict the use of Social Stock Exchanges by social enterprises which cannot visibly target a section of under privileged population, for instance technology start- ups or social enterprises focused on or supporting broader sustainability goals such as climate, water sanitation, diversity and inclusion, healthcare, innovation, or skill development.

The current regulations only permit non-profit organisations to be listed on the Social Stock Exchange even though the working group recommendations had envisioned the listing of for-profit social enterprises as well. It has been clarified that securities issued by for-profit social enterprises shall be listed and traded under the ordinary segment of the stock exchange with an identifier stating that the scrip is that of a for-profit social enterprise. In addition to the criteria for social enterprises, for- profit social enterprises would be required to meet the eligibility criteria and rules applicable to all listed companies, such as listing requirements for raising capital, a minimum public float, extensive corporate governance committees, public offer rules for capital raising and transfers.

Excluding for-profit social enterprises from the Social Stock Exchange platform and subjecting them to the extensive compliance regime applicable to ordinary listed companies, may disincentivise institutional and retail investors from investing in impact projects that generate outcome-based returns.

4 Green Bonds

A specific legal framework is provided with respect to the issue of 'green bonds' by listed companies, under the SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021 (SEBI NCS Regulations). The NCS Regulations define green debt securities (GDS) as debt securities the proceeds of which are entirely utilised towards any of the specified 'green' activities, such as renewable and sustainable energy, clean transportation, sustainable water management, climate change adaptation, energy efficiency, sustainable waste management, sustainable land use, and biodiversity conservation. The recently circulated SEBI Consultation Paper on Green and Blue Bonds recommends increasing the ambit of qualifying green activities to include activities related to pollution prevention and control and circular economy.

Both the NCS Regulations and the AIF regulations define green activities and social impact activities in the context of investments in (or the issue of) quoted debt securities by listed entities. However, there are inconsistencies in the two definitions. There is also a lack of national legislation or policy that comprehensively defines the ambit of sustainable activities in the country. A national taxonomy or classification system for sustainable finance will provide clarity to financial investors and companies on what activities qualify as sustainable and are accepted as contributing towards the country's sustainable development goals, nationally determined contributions (NDCs), or net zero objectives. A precedent to replicate is the harmonised master list for infrastructure sector/sub-sectors, which was introduced by the Government of India to bring uniformity to the definition of infrastructure and allow certain benefits including access to easier borrowings, ability to raise funds through tax-free bonds, tax concessions, and access to dedicated infrastructure lenders and funds for infrastructural development. A taxonomy for sustainable finance could establish a clearer criteria for green/impact labels, including minimum contribution, safeguards and technical screening criteria. Defining 'green', 'sustainable' and 'impact' under a national taxonomy with more precision, will help investors and corporates to better channelise their capital and resources to bolster the impact sector, and will also serve as a guideline to different regulators and government agencies when applying legal policies to support the impact sector.

Further, impact instruments like green bonds have a high borrowing cost due to the information asymmetry existing in the market. Since there is no national measurement and reporting platform for tracking green finance, the uncertainty over the performance of green bonds leads to high borrowing cost, visible in the above market coupon rates that green bonds generally offer. The additional disclosures proposed by SEBI in its Consultation Paper on Green and Blue Bonds are a step in the right direction. For instance, SEBI has proposed mandatory disclosures regarding the international taxonomy or regulation that the borrower proposes to align its underlying green project with, for the purpose of reporting environmental impact.

However, currently there are no specific disclosure norms for green loans, sustainability-linked bonds or other impact instruments. Introducing a national disclosure regulation for sustainability projects (like the one adopted by the European Union), could be hugely beneficial to the impact sector as it would provide transparency to investors on the sustainability policies, targets and risk mitigation to be followed by the borrowers.

5 Social Impact Company as a separate category

While the Indian company law recognises not for profit entities set up as Section 8 companies, there is no specific recognition to for-profit social enterprises that undertake the twin goals of social and financial returns. A few jurisdictions recognise distinct corporations aimed at social impact called “community interest company” with eased compliance burdens. In 2019, a High-Level Working Committee on CSR under the Ministry of Commercial Affairs of India had recommended the creation of a category for companies aiming to make measurable social impact with a reliable business plan, i.e., a “social impact company”. Such companies could be given the benefit of an eased compliance framework so long as they satisfy specified parameters for project selection and disclosures and follow an “asset lock” to ensure that a portion of the profits are re-invested into the project while the remaining is distributed to the investors. Creation of a separate category of social impact company with eased norms for compliances, tax and other benefits could spur both small and large-scale impact activities and attract more focused capital from investors.