Bond Case Briefs

Municipal Finance Law Since 1971

Startup Seeks Cities to Test Bonds that Put a Twist on Pay-for-Success.

Neighborly wants to try a kind of risk-reducing bond to finance infrastructure projects that have an element of uncertainty to them.

It can be difficult for government to try new things. If one is spending taxpayer dollars, and under constant public scrutiny, and has an enormous legal broadside, it tends to make one risk-averse.

So what if someone else took on part of the risk of uncertainty?

That's the thesis Neighborly is starting from. The municipal bond-focused startup has announced a new program that puts a spin on the pay-for-success concept and is seeking a couple local government projects to put the idea to work. It's called an environmental impact bond (EIB).

Thus far, pay-for-success projects have mostly taken the form of social impact bonds (SIB), which tend to focus on many of the same areas charities do: reducing criminal recidivism rates, helping children in the foster care system, etc. The projects were met with enthusiasm from government, but are still a relatively new concept and have faced skepticism from researchers because of their complexity and the sudden crumbling of certain programs.

The EIB differs from the traditional SIB in two big ways: payments and area of focus. Where SIBs call for the government to pay for a project only in the event of measurable success, EIBs establish a sliding scale of payment. Where SIBs focus on services, the EIB concept appears more readily geared toward hard infrastructure.

The payment part is a particularly large departure. After all, an early SIB in New York City failed because the investor pulled out for fear of the program not meeting its goals — and thus not requiring the city to pay back the bond. With EIBs, the city must still pay back the bond if the project doesn't meet its goals. The payback simply becomes smaller in the event of failure.

From an investor perspective, return on investment (ROI) disappears, but at least they don't lose everything they put in. From a government perspective, they still must shell out money for a failed project, but at least it's a smaller payment.

The opposite is also true under an EIB: If a project is more successful than anticipated, the government that issued the bond must pay more, and then the investor generates an unexpectedly good ROI.

As George Hawkins, CEO of the District of Columbia Water and Sewer Authority puts it, it's like a bond with insurance.

"Most insurance policies you pay a premium no matter what," Hawkins explained. "In ours, we only pay the premium if it works for us."

DC Water's project, which involved using water-absorbing "green infrastructure" instead of tunnels to help avoid too much rainwater overwhelming the sewers, was a sort of trial balloon for the concept. In that instance, they issued the bond privately to Goldman Sachs and the Calvert Foundation.

In Neighborly's project, the startup is looking to open up the bonds to a wider pool of purchasers. In fact, that's what Neighborly was founded to do — the startup's goal is to allow average people to buy municipal bonds. In the context of EIBs, then, people could use the platform to invest in environmental projects in their own cities and then earn a payback on it.

"The humble municipal bond is the original impact investment," said Neighborly CEO Jase Wilson. "It's been funding things like parks and schools and libraries since longer than that's been a term."

The Neighborly program isn't limited to projects to absorb rainwater, either. In preliminary talks with cities, Wilson said he's heard ideas ranging from sea walls to electricity microgrids.

"We don't know what happens when we open the flood gates on the project, but it's shown us that there's a world of innovative projects waiting to be financed," Wilson said.

And there are, potentially, a lot of areas where the project's organizers think the model could work. Because the purpose of the EIB is to provide peace of mind through risk reduction, it could theoretically apply to any project where the government isn't totally sure that the project would work.

Take D.C., for example. Green infrastructure has proven successful in plenty of places, but that success tends to hinge on things like what type of soil the green infrastructure will sit on. Others have examined this type of bond for a program helping farmers implement best practices to avoid pollutants entering local water supplies, or setting up a program to help reuse materials from deconstructed homes instead of simply demolishing the structures.

A key aspect of such bonds is setting up the performance metrics. That's where Quantified Ventures (QV) comes in — in the Neighborly project, they'll be aiming to structure the bonds so that the most likely scenario results in a middle-of-the-road bond payment. Just as important, they'll be working out what constitutes underperformance and overperformance.

The Rockefeller Center is supporting the initiative through a grant that will pay for QV's and Neighborly's support services. Should the projects prove helpful to governments looking for ways to try out new things, the program's organizers will be looking to try it out on a larger scale.

"Rockefeller is trying to promote a wider market for this," said Todd Appel, QV's impact director. "So our thinking, and Rockefeller's, is if we had a couple different examples, different locations, maybe a couple different design features, that that will help facilitate adoption of the model."

GOVTECH

BY BEN MILLER / AUGUST 16, 2017