SRI bond funds are set to sail on the rising tide of Green and Social bonds

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Sustainable debt securities experienced spectacular growth in 2013. As the vehicles of highly specific social or environmental benefits, these financial instruments have proven seductive for socially responsible investors, as demonstrated by the increasing numbers of issues. Initiatives aimed at providing a framework are now underway in order to consolidate this expansion and support further development.

A sustainable security is a debt instrument floated on the open market for the purpose of financing a project that offers a specific social or environmental benefit. The securities we will address here are environmentally dedicated 'Green Bonds' and socially oriented 'social bonds', often categorized together as 'sustainable' or 'impact' bonds.

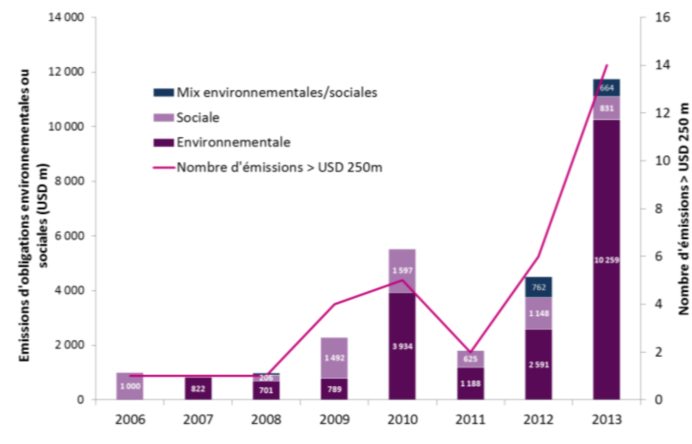
2013, the year of the green bond

In 2013, the market woke up to the importance of green bonds. Even if such bonds remain a niche market for now, with around USD 11 billion issued in 2013 compared to a fixed income market of USD 95 trillion in 2011, green bonds are attracting more and more issuers (development banks, local authorities, companies, banks). The rise of this relatively new financial product can be attributed to funding limitations plaguing both governments and banks, coupled with increasing awareness of the need to address sustainable development issues on the part of financial leaders such as Christine Lagarde, Director of the IMF. This concatenation of factors has favoured sustainable and impact bonds as a solution to the funding gap.

The first widely known green bond was issued back in 2007 by the European Investment Bank. This was quickly followed by an offering from the World Bank (which has since issued over USD 4 billion in sustainable bonds) and many other multilateral banks.

Last year, bonds from France's EDF's (EUR 1.4 billion issue) and Merrill Lynch-Bank of America (USD 500 million issue) finally put an end to the hegemony of multinational banks over green bond issuance.

Figure 1 : Yearly Social and Environmental bond issues (USD mi)



Source: Credit Agricole CIB/Mirova, 2013

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> " As a first step, we should aim to double the green bond market and reach $20 billion by the September summit. JIM YONG KIM, DAVOS 2014

Social Impact bonds offerings: still hazy

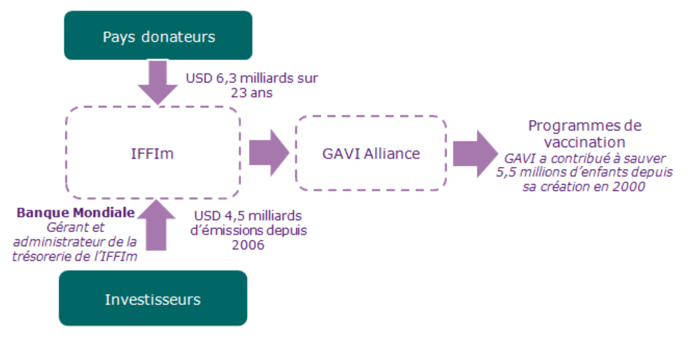
Social impact bonds, however, remain rare compared to green bonds. Nonetheless examples do exist, such as the social impact bond for prisoner rehabilitation issued by the UK in 2010, the social bond for medical home care issued by Air Liquide in 2012 and the World Bank's women's bond, which last year raised money for businesses owned by women in emerging countries. In this field, however, the most fully developed offering remains the 'vaccine bond'.

First launched in 2006, vaccine bonds are a perfect illustration of how financial innovation can help promote sustainable development goals and thus have a positive impact on the real economy.

Vaccination offers the best solution in developing countries that have high rates of infant mortality. Furthermore, in addition to being the most efficient lever for combatting infant mortality, vaccination is in line with a transformation of the healthcare sector to privilege prevention and care that ensures health, rather than focusing on the treatment of disease.

On the basis of a realization that the deaths of nearly 1.7 million children could be avoided simply through vaccination, some of the world's largest organizations dedicated to change joined their efforts to achieve a lasting solution, forming the Global Alliance for Vaccines and Immunization (GAVI). This partnership between the public and private sectors was created in 2000 to combat lack of access to vaccination against potentially fatal common diseases and encourage the development of new vaccines through increased R&D in developing countries. In order to accelerate availability and ensure the stability of funding for GAVI vaccination programmes, the International Finance Facility for Immunisation (IFFIm) was created in 2006 by a coalition of European nations.[1]

Figure 3: How Vaccine bonds work



Source : GAVI/Mirova, 2013

The IFFIm relies on long-term commitment to giving by countries to issue bonds in the capital markets against these donations. The IFFIm has succeeded in raising USD 6.3 billion in pledges from nine sovereign donors[2] and USD 4.5 billion from investors.

GAVI publishes performance indicators to illustrate the effectiveness of its actions. For example, 145 million children have been vaccinated thanks to GAVI since 2010.

The transparency of GAVI's activities makes it possible to know the impact on the real economy of an investment in vaccine bonds. The one criticism we might level at such securities is that they are closer to donations where the markets are used to leverage a commitment by states than they are to real investment financing.

Eager investors are still waiting for the social bond market to really take off. No studies have been undertaken to identify barriers, but one could make an educated guess that defining and, especially, evaluating social projects is more complex than describing or categorizing renewable energy programs.

[1] *The United Kingdom, France, Italy, Spain, Sweden.*

[2] *The United Kingdom, France, Italy, Norway, Australia, Spain, The Netherlands, Sweden and South Africa.*

> “ First lanched in 2006, vaccine bonds are a perfect illustration of how financial innovation can help promote sustainable development goals and thus have a positive impact on the real economy

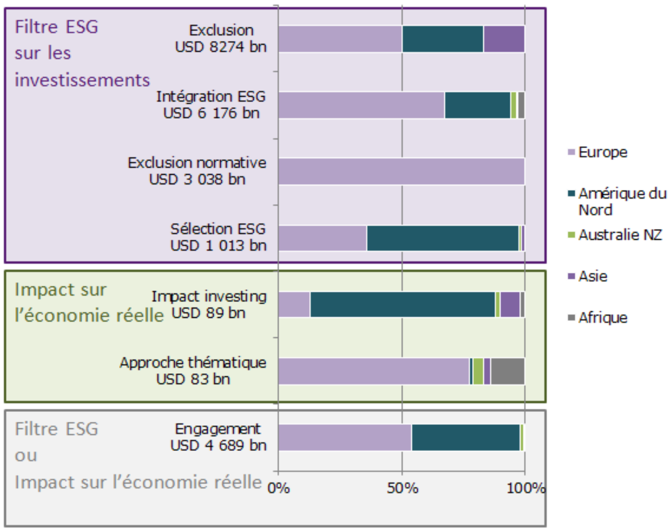
Indeed, both potential issuers and hopeful buyers for social bonds find themselves confronted with the difficulty of identifying reliable indicators of social performance. Improvements in transparency and a framework for establishing norms would greatly help to structure the still halting issuance of social bonds.

In what ways do sustainable bonds address the expectations of SRI investors, including Mirova?

According to the French Asset Management Association (AFG), Socially Responsible Investments, or SRI, is ‘an investment that seeks to reconcile economic performance and social or environmental impact by financing public and private sector entities that contribute to sustainable development…’ While this definition is widely shared, SRI can take several forms. Two broad philosophies can be distinguished:

- Investors seek to avoid the most controversial companies and favour those with the best social and environmental practices
- Investors seek to have an impact on the real economy through their investment by financing companies whose products offer solutions to issues of sustainable development.

Figure 2: Current SRI strategies



Source : Global Sustainable Investment Alliance (GSIA)/Mirova, 2013

Sustainable bonds correspond perfectly to the needs of those investors who are seeking positive impact rather than a process of exclusion; they offer an opportunity for savings to participate in investments with an objective social or environmental return. First of all, they are investments, not debt refinancing operations, leveraged buyout manoeuvres, liquidity stop-gaps or some combination of the above, but specifically and exclusively *investments*. Secondly, they are environmentally or socially beneficial; by clearly identifying what is invested in, they make it easier to highlight the social or environmental impact than it is when capital is placed with a whole company, which often has by its very nature a large number of impacts that are difficult to quantify.

Such bonds thus make it possible to sink capital into the financing of socially useful and profitable projects. Is this not the first and foremost function of the financial markets?

From self-styled market to stricter standards

However, until now, the sustainable bond market has been self-described, following no consistent set of definitions or requirements as to transparency. Much needed efforts to advance the question of standardization, however, have started to emerge. The Climate Bond Initiative, a project aimed at mobilizing the bond markets for climate change solutions, has launched the Climate Bond Standard, which offers detailed criteria for what should be considered green. Concurrently, however, the Green Bond Principles, a voluntary set of guidelines proposed by a consortium of major investment banks, does not propose a definition for green. Instead, it suggests a process for designating, disclosing, managing and reporting on a green bond to ensure adequate transparency and governance, believing that it is up to each investor to forge his or her own opinion. Investors too need to get behind the establishment of principles like these that can consolidate the market. Likewise, we encourage the establishment of similar principles or guidelines for social bonds, which are even more complex and difficult to define.

Mirova supports these initiatives, as we believe they are important for increasing the transparency, legitimacy and liquidity of the market. What appears to us essential to preserve across attempts to standardize green bonds is the logic of positive impact: at their core is participation in financing the ecological transition. This entails:

- The establishment of a system for rating environmental impact, ideally one making it possible to create an accreditation for funds holding such bonds.
- Securing the link between green bond issuance and new investment. In particular, the issue of refinancing green bonds when they achieve maturity will arise. As we see it, such refinancing should be possible as a green bond only for that portion of the underlying project not yet amortized.

In the meantime, while recognized standards are developed, we have our own internal system for considering sustainable bonds, which relies on four pillars: (1) strict criteria for projects and activities considered to ensure they offer direct environmental or social benefits, (2) a review of socio-environmental risks throughout the project's life cycle, including supply chain, (3) traceability of the funds to identifiable projects or activities, and (4) reporting that involves a detailed description of the projects, including an estimate of their anticipated benefits and regular updates on their development.

Conclusion

Standardisation efforts aside, sustainable bonds will find a welcome place in SRI funds if companies and states follow the way already in large part paved by supranational institutions and local communities. Companies stand to gain by offering SRI investors broader offerings in terms of credit ratings, and thus returns. States should join because this is the core function of their bond issuances. In fact, if the latter party were to support the development of extra-financial reporting they might be better able to exploit, as borrowers or investors, the powerful financial lever they have available to promote good CSR practices.

Mirova believes that sustainable bonds are a very effective way for investors to address the challenges of sustainability. We welcome the boom in green bonds and encourage the market not only to continue growing, but to develop creative and responsible ways of addressing societal issues through social bonds as well. However, a minimum of standardization of this new product will be crucial for its success, and we have thus supported and contributed to its development through consultation. We do, however, have our own internal standards to ensure that we invest only in green bonds that are aligned with Mirova's principals from a socio-environmental and governance perspective. More than 8% of our flagship fund, Mirova Euro Sustainable Aggregates, today consists of sustainable bonds, and we look forward to contributing to the growth of the market as investors and stakeholders.

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