Daiwa Capital Markets
50 YEARS IN LONDON

SRI Bonds




Innovative Finance

SRI Bonds

Concern about the environment is increasingly evident, and investors globally, both individual and institutional, are now looking for more than purely a monetary return. Some choose to make a one-time positive impact on a local society, while others make social responsibility a focal part of their investment strategy. Whichever the objective, Socially Responsible Investment ("SRI") is now rapidly developing across asset classes, and more recently, it has also been gaining greater momentum in the fixed income space through **SRI bonds – the market which Daiwa entered from an early stage, and where it has remained a leading participant.**

What is Socially Responsible Investment?

Socially Responsible Investment does not have a single, particular definition. Rather, it **represents an approach to investment that explicitly acknowledges the importance of environmental, social and governance (ESG) factors.**

The SRI concept is by no means new. Originating in the 18th century, SRI became increasingly prevalent only during the 1960s, addressing concerns about civil rights and the Vietnam War. And its scope has broadened subsequently, most notably to address environmental concerns, but also those around tobacco production and arms manufacturing, among others. Historically, the SRI concept has been most prevalent in the world of equity investment.

In the fixed income world, SRI long meant adopting a "negative screening" approach – excluding certain securities based on environmental/social considerations. But recent years have seen the rapid growth of fixed income instruments designed to attract the new generation of "positive" SRI investors - those investing in instruments that are specifically intended to have a positive social or economic impact.

What are SRI Bonds?

As with the broad definition of SRI, there is no single, uniform definition of what constitutes an SRI bond. However, typically, SRI bonds are fixed income instruments issued by organisations to raise funds for a specific purpose or project which adheres to ESG principles.

Examples include bonds issued to raise funds for the provision of immunisation to children in developing countries, and those issued to fund the supply of water in disadvantaged regions. As such, SRI bonds offer a direct and unique way to fund specific ESG projects or initiatives, meeting the needs of both investors and issuers.

Although SRI bonds are issued to fund a specific initiative or project, they differ from project finance in that they carry the credit strength of the issuer, as opposed to that of a specific project to which the funds are channelled.

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Why invest in SRI Bonds?

The single greatest benefit of SRI bonds is the ability to have **direct influence on the associated environmental, social and governance** aspects that these investments encapsulate.

SRI bonds can also be **reputation enhancing for both the investors and issuers** in the eyes of their stakeholders. This factor may provide the greatest marginal benefit to those institutions and industries which have hitherto been under public scrutiny for their neglect of ESG aspects in their day-to-day business.

To date investors have not been required to pay any premium relative to a borrower's curve for the privilege of investing in SRI bonds, neither are there any additional costs incurred by the investor. Borrowers may incur certain resourcing or legal costs to ensure fund segregation, project eligibility, and monitoring standards are upheld.

The Universe of SRI Bonds

As mentioned earlier, the definition of SRI bonds is relatively broad. This has led to the creation of a wide range of naming conventions for SRI bonds, driven by the intended use of the proceeds. Some of these which Daiwa has been involved with are:

Green, Environment, CO2-linked, Climate Awareness Bonds – these refer to those bonds whose proceeds will be used primarily for financing projects that seek to mitigate climate change, help affected people adapt to it and/or aid in the transition to a low carbon economy. One of the larger and more recent issues in this category includes KfW's 5-year €1.5bn EMTN bond launched in July 2014.

Poverty Reduction Bonds – aimed at supporting programmes designed to alleviate poverty and improve living conditions in a specified region. An example is IDB's 3-year BRL399mn Uridashi bond issued in January 2011.

Banking on Women Bonds – proceeds from these bonds are used to increase access to finance for female entrepreneurs. The issuance of these bonds began with IFC's 5-year US$165mn Uridashi bond in November 2013.

Vaccine Bonds – aimed at funding better access to immunisation programmes for children in emerging countries, as well as strengthening health systems in developing regions. An example is iFFIM's 3-year US$700mn bond issued in June 2013.

Daiwa lays claim to an impressive 56% share of the Japanese market for SRI Bonds, having organised issues for a wide array of institutions such as the **World Bank**, the **IFC**, and the **European Investment Bank.**

Total sold: Approx. US$10.23bn

(Since March 2008)
Source: Daiwa Securities - Bonds for retail investors only, excluding expected sales as of 29/08/2014

Microfinance Bonds – focussed on supporting viable microfinance institutions by expanding access to finance for poor and low-income entrepreneurs in developing countries. One example includes EBRD's 3-year ZAR726mn Uridashi bond issued in June 2010.

Water Bonds – proceeds from these instruments are aimed at increasing general water project investment both in urban and rural areas through increasing water supply efficiency, improved water resources and wastewater management. One of the latest examples includes ADB's 3-year BRL283mn Uridashi bond issued in January 2014.

Agri Bonds – aimed at supporting projects, lending and other financial aid to enhance sustainable business practices in the agribusiness in developing countries to reduce environmental degradation and increase the livelihood of the population working in, and dependent on, agriculture. In February 2013, Rabobank raised an equivalent of €160mn through 4-year ZAR and 5-year AUD GMTN Agri Bonds.

Infrastructure Bonds – these bonds are issued to channel resources for infrastructure development towards disadvantaged regions in emerging markets. One example includes AfDB's 7-year US$200mn private placement completed in July 2014.

Education Bonds – proceeds from these bonds are directed at projects in the field of education and hence at fostering economic and social growth in disadvantaged regions. AfDB issued a 5-year ZAR1bn Uridashi Education Bond in March 2013, and, in a related field, IDB issued a US$500mn 4-year "EYE" (Education, Youth, and Employment) Bond in September 2014.

Quality assurance

SRI bond investors and issuers have a shared goal of contributing to ESG initiatives. In addition to this general mutual commitment, there are a number of reassurances that strengthen investors' confidence around the intended and adequate use of bond proceeds.

Best efforts and segregation

The concepts of best efforts and segregation (also referred to as ring-fencing) relate to the clauses that ensure the appropriate use of proceeds from bond issuance. Under best efforts the issuer essentially does its best to channel the funds towards the specific purpose they were intended for. In the case of ring-fencing, the issuer segregates the funds raised in a separate dedicated sub-account, which will later be directed towards disbursements made to eligible ESG projects.

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Project selection and eligibility

Eligibility criteria are defined by an issuer and specify the characteristics that an ESG project must possess in order to be considered for inclusion in an SRI programme. A project's conformity with these benchmarks is determined by the issuer's social sector specialists. In general, the eligibility criteria for SRI bonds do not have a global, standardised definition and are rather specified on a project-by-project basis, catering to the needs of both investors and issuers.

In some instances, however, there are certain globally-accepted principles for specific categories of SRI bonds. One such example is the Green Bond Principles, created by a group of financial institutions in January 2014. These represent a set of voluntary guidelines that encourage transparency and disclosure and promote integrity in the development of the Green Bond market by clarifying the approach for issuance of a Green Bond.

Another example is the Climate Bond Standard developed by the Climate Bond Initiative, which links the bonds to low carbon project assets or activities, offering investors additional assurance over the use of proceeds.

Monitoring standards

In order to provide even greater confidence to investors around the use of issuance proceeds, a number of independent organisations, e.g. Cicero, Bureau Veritas, Vigeo and DNV-GL, offer certifications asserting that specific bonds meet certain international standards in terms of their contribution to sustainable development.

Although not yet widely adopted or mandatory, some SRI issuers may equally choose to employ auditors to provide investors with a further assessment of the use of proceeds as well as, in some cases, the effectiveness of the projects being funded.

Background & development

The last two years have witnessed a transformation of the fixed income SRI market from a small niche market to an established and ever growing asset class, receiving more and more attention from issuers, investors and the media alike. What originally drew its strength from the retail targeted Uridashi market, with Daiwa leading the first SRI "Themed Bond" for IFFIm in 2008, as well as private placements and other peripheral markets, is now seeing benchmark sized transactions across a large spectrum of issuers, currencies and products.

The SRI market made its first breakthrough in 2013, largely driven by inaugural benchmark Green bonds by SSA issuers such as the IFC (US$1bn), the EIB (€650m) as well as the AfDB, NIB and the IBRD among others. An important force in the growth of the SRI space were the first corporate and FIG issuers to brave the market, accounting for ca. 30% of SRI issuance volumes in 2013, including Green Bonds by, for example, BofA (US$500m) and EDF, who issued the largest Green Bond at the time (€1.4bn).

Another significant development that year was the issuance of the first real non-Green benchmark SRI bond in the form of IFFIm's first "Vaccine Bond" benchmark (US$700m FRN).

Current environment & trends

Total SRI Bond issuance stood just shy of US$11.5bn in 2013; this record number was eclipsed within a few months in 2014 as issuance volumes exceeded US$18bn in the first half of 2014 alone, and exploded to over US$31bn by mid-October.

The onslaught of SRI issuance in 2014 was underscored by a significant increase in corporate transactions during the first half of the year. The likes of Unibail, Iberdrola and GDF Suez contributed to an impressive US$10bn of corporate SRI bonds in H1 2014 alone, with the latter issuing the largest Green Bond transaction to date (€ 2.5bn across two tranches). Corporate issuance was accompanied by significant SSA volumes which, unlike corporate volumes, did not decline in H2 and, at close to US$18bn, account for ca.57% of total SRI issuance YTD.

While the EIB remains the largest issuer in the SRI space by volume (ca.US$4.7bn equivalent in 2014), a number of debut issuers have made a significant impact on the market this year.

The most notable debutant is undoubtedly KfW, who issued both the largest EUR and USD Green bond benchmarks to date (€1.5bn issue in July and a US$1.5bn issue in October), catapulting the agency to a top five issuer rank in the SRI market.

Other debut issuers include corporates such as Unilever and GDF Suez, as well as SSA issuers such as NWB, NIB (debut USD Green bond) and most notably DBJ. DBJ's Green bond (€250m) not only represents the issuer's inaugural SRI bond, but also the first SRI bond ever issued by a Japanese institution in the international markets. This milestone transaction is testament to the growing awareness of the SRI market by Japanese issuers and investors alike, and has opened a new frontier for the SRI market.

The most dominant currency this YTD has been the EUR, accounting for 53% of SRI issuance. While USD and EUR volumes were quite balanced in 2013, USD issuance is trailing behind this year at 27% of total issuance but has picked up in H2 on the back of large benchmarks by the likes of KfW and EIB. The success of recent USD SRI benchmarks will most likely result in increased USD volumes going forward. High EUR volumes were largely driven by a wave of benchmark corporate transactions in H1 which has since subsided. Nevertheless, the EUR continues to be the dominant currency in H2 so far.

The most dominant peripheral currency in the SRI market remains SEK, testament to Scandinavia's lead role in the SRI space, followed by GBP and CAD. Both the Sterling and the CAD market witnessed their debut SRI transaction this year, inaugural Green Bonds by Unilever (£250m) and TD-Bank (CAD500m) respectively.

The SRI universe has expanded not only in terms of issuers and currencies, but has also seen a host of different product classes and SRI themes make their debut in 2014, including the first ever Green ABS issued by Toyota (linked to hybrid and electric vehicle loans) and the first ever SRI covered bond issued by MunichHypo (linked to cooperative and sustainable housing schemes). Another major development for the market was the first SRI themed Samurai Bond, issued by the EIB under its Climate Awareness Bond (CAB) scheme. The JPY 5bn transaction was launched in response to growing demand for SRI themed products by Japanese investors, specifically highlighting the momentum the SRI market is gaining in Japan, and generally demonstrating the growing traction and presence of the SRI market as a whole.

The SRI market has been, and still is largely dominated by Green themed issuance linked to such topics as renewable energy, clean water, and green buildings to name a few.

This year has seen a number of transactions with more of a social theme, such as the afore mentioned MunichHypo covered bond, as well as Lloyd's "Environmental, Social and Governance" (ESG) bond. Proceeds of the £250m transaction go one step further than regular Green bonds by supporting projects and activities that deliver social benefits beyond the environmental aspect. Most notable however was the IADB's Education, Youth and Employment (EYE) bond. Lead managed by Daiwa, the EYE bond represents the first global benchmark issued by an MDB that strictly supports projects related to social development. Demand for such innovative themes is growing, particularly by Japanese investors who took up 12% of the inaugural EYE bond. Another transaction placed in Japan by Daiwa is the first "Infrastructure for Africa" bond by the AfDB (US$200m).

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