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DUTCH DEVELOPMENT BANK FMO AIMS TO BRING RESPONSIBLE INVESTMENT INTO THE MAINSTREAM WITH ITS SUSTAINABILITY BONDS. SHEILA CODAMUS-PLATEL EXPLAINS

In a dismal economic environment marked by the ongoing eurozone crisis, looming US fiscal cliff and slowdown in China, among other concerns, finding safe, yet responsible, investments and hedging strategies can be hard.

This was the very challenge that faced KLM Royal Dutch Airlines, which wanted nothing less than a high-quality investment that it could use to manage its currency risk and support its sustainability initiatives. Hence a sustainability bond issuance by FMO, the international development bank of the Netherlands, attracted its interest.

FMO has always wanted to reach out to investors with a leaning towards sustainable and responsible investment (SRI), considering them a natural investor base given the nature of its operations and organisational philosophy. (See box, opposite.) It also wanted to meet demand in the SRI market for additional plain, vanilla, fixed-income products from issuers that corporates and institutional investors could realistically invest in within their treasury mandates. At present, most SRI investments in the market can meet investors' yield requirements, but not their security and liquidity demands.

On 12 July 2012, FMO issued $41.3m in six-year, zero-coupon sustainability bonds, with the lead order for the transaction coming from KLM. Vijay Panday, director of treasury and risk management at KLM, says the airline was pleased to invest in the sustainable bonds. "It combines our financial strategy to further reduce our US dollar currency risk and our business strategy to be an industry sustainability leader," he explains.

Bond features

FMO's sustainability bonds stipulate environmental and social requirements that will be applied to all its financing activities.

In addition to an exclusion list, which states activities that FMO will not finance (for example, forced or child labour, illegal products or activities, weapons and munitions, tobacco and hard liquor), FMO applies the International Finance Corporation Performance Standards on Environmental and Social Sustainability (IFC PS) to all its financing activities, regardless of asset class.

In practice, this means that every opportunity is assessed against the relevant performance standard, categorised and, if necessary, action plans are agreed with the client in order to improve their environmental, social and governance (ESG) performance. Action plans are monitored to ensure timely completion during the term of the financing. In July, FMO was awarded the top ranking out of a peer group of 24 financial institutions scored by rating agency Sustainalytics.

Given FMO's AAA rating (Standard & Poor's) and the solid backing of the Dutch state, it

is a real option for institutional investors that want to integrate ESG considerations into their mainstream investment portfolio.

Although the proceeds of FMO's sustainability bonds will be used to invest in projects that are, by their very nature, high risk, the cash flows on the bond are not linked to the credit risk of the projects as the issuer of the bond is FMO. So the counterparty risk the investor is exposed to is that of FMO.

This, therefore, allows investors to support the sustainable economic growth of the private sector in developing and emerging countries without eroding their own risk-return profile.

Since the issue, FMO has attracted more interest from other corporates and institutional investors in its sustainability bonds. (Last month, FMO issued a further €40m in five-year sustainability bonds with the lead order from sustainable bank Triodos.) It is attractive because it can be flexible in terms of the notional amounts, tenors and currency in the bonds it can issue as part of its global medium-term note (GMTN) programme on a private placement basis.

Trends in SRI

The integration of best practice ESG standards and criteria is slowly, but surely, penetrating mainstream investing. According to the European Sustainable Development Forum (Eurosif), the global SRI market had reached an estimated €5 trillion by 2010.

While theme-based investments are still predominantly found in the equity space, fixed-income products have become increasingly common in the market in recent years. For instance, supranational banks have issued green bonds (World Bank), education bonds (African Development Bank), climate awareness bonds (European Investment Bank), poverty reduction bonds (Inter-American Development Bank) and water bonds (Asian Development Bank) to name a few. As you would expect, the proceeds of these bond issuances are used to finance projects on the specified themes.

The use of specialised, extra-financial rating agencies to score sustainable and responsible investments is gradually increasing. This is mainly among private insurers, mutual insurance companies and private, corporate or public pension funds, but also, to a certain extent, among banks, public financial institutions, NGOs, foundations, religious institutions and trade unions.

Broadly, there are two major SRI strategies used to select investments, namely negative screening and positive screening. Negative screening or 'exclusion' consists of barring investment in certain companies, economic sectors, or even countries, for ESG reasons. Common exclusion screens include armaments and nuclear weapons, alcohol manufacture and promotion, environmentally damaging activities and poor employment practices. Positive screening, the most popular form of which is the 'best-in-class' approach, is the selection within a given investment universe of companies that perform best against a defined set of ESG criteria.

Different and opposing views exist in investment circles as to whether fiduciary duty is consistent with ESG criteria being integrated into the investment process. These are well exemplified by the British view that negative screening reduces diversification, whereas the continental European view, put forward by Eurosif, is that the positive screening approach adds value as it reduces risk and increases profit potential through a more thorough portfolio analysis that integrates ESG considerations.

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Market outlook

A changing business climate has increased investors' appreciation of ESG. ESG criteria have emerged as part of the mainstream investment process, bringing with them the availability of SRI products on a wider scale, following a spate of high-profile corporate governance scandals and legislation in the UK, Australia and France. In these countries, fiduciaries such as pension funds are legally required to address environmental risks in their investment strategies, something that FMO was already doing 20 years ago.

But the mainstream investment community still considers SRI as marginal for reasons that include the perceived unattractiveness of returns, lack of liquidity and significant upfront due diligence costs. SRI products need to have the right economic incentives to attract corporates and institutional investors.

Likewise, it remains a challenge to raise awareness of SRI to bring it to mainstream asset-class level since it is still widely perceived as a niche or alternative investment.

FMO will continue in its efforts to make SRI the gold standard in a treasurer's toolkit. It will do this, among other means, through catalytic development work, the use of more innovative financial instruments, and by demonstrating the value of sustainability to the rest of the financial sector.

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ABOUT FMO

◆ Sustainability is crucial to FMO's existence. As the international development bank of the Netherlands, its mandate is to support the sustainable development of the private sector in Africa, Asia, Eastern Europe and Latin America.

◆ Founded in 1970, FMO is a public-private partnership with 51% of shares held by the Dutch state and the remaining 49% held by commercial banks, trade unions and other private-sector representatives. FMO has an AAA rating from Standard & Poor's.

◆ The Dutch State Guarantee has enabled FMO to invest in the world's most difficult markets for more than 40 years.

◆ Prudent risk management has meant that FMO's non-performing loans were at less than 4% as at 31 December 2011, which is low given its markets are in low- and middle-income countries.

◆ FMO is not a charitable organisation, NGO or aid donor. It believes strongly in supporting the profitability of its clients in order for FMO to stay profitable and fulfil its mandate sustainably into the future.