CLIMATE FINANCE ESSENTIALS

# ADAPTING INVESTMENT PRACTICES TO FINANCE THE SUSTAINABLE DEVELOPMENT AGENDA: FROM ESG PRACTICES TO IMPACT INVESTING

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## Introduction

The successful implementation of the 17 Sustainable Development Goals (SDGs) developed by the United Nations, which came into force in 2015, is a financial challenge, as it hinges on the mobilization of private investment, in a context of strained public finances. That is why the private sector, supported by States and intergovernmental organizations, has progressively developed projects as well as financial methods to invest in projects that aim at facing the challenges related to climate change. The challenge is indeed not to find new financial resources, but to redirect existing financial flows toward sustainable development.

Investing in sustainable development can take a wide variety of forms but two central issues can be discussed here: (i) first of all, to what extent the "traditional financial sector" (i.e. institutional investors; investment funds...) is adapting its investment practices to sustainable development; and (ii) second of all, how impact investing has developed over the past decade, to reach a total of roughly USD 115 billion worth of assets in 2017.

## The ESG approach to investment: a tool for more sustainable investing


While the first ethical funds were set up in the beginning of the 20th century, a wide variety of sustainable investment strategies have developed within the financial sector over the past few decades (i.e. socially responsible funds; long-term public institutional investors promoting responsible investment policies; non-financial rating agencies; ESG labels). In the meantime, more traditional financial actors have also developed more responsible investment strategies and new regulations have come to develop an ESG approach to investment, progressively aiming to **consider ESG policies as a "must have" in the financial world**.

The absence of a bespoke regulatory framework or specific standard for socially responsible investment has been a real factor in the proliferation of investment management methods and investible asset classes, while hindering clarity for the end investor. **Investors need indeed to be able to form their own opinion on the robustness of their investment in terms of social responsibility** (i.e. exclusion of certain business sectors for ethical reasons; investment in companies deemed to behave responsibly; positive impact on social, environment and governance issues; etc.).

Management companies therefore need to make sure their investment strategies and the information they disclose are transparent, accessible and reliable enough.

Therefore, while the premises of ESG disclosure can be found, as far as the French regulatory framework is concerned, in a 2001 regulation (to which were added new requirements in 2011 with regard to societal responsibility and the extension of the scope of reporting entities covered), **article 173-VI of France's Law on Energy Transition for Green Growth**, and its associated decree are groundbreaking. Both drafted in the context of the COP21 and adopted in 2015, they have turned France into the first country in the world to specifically ask investors to disclose information concerning their contribution to climate goals. They also represent a major innovation in terms of regulation, as they apply the "comply or explain" principle, providing investors with broad flexibility in choosing the best way to fulfill the law's objectives in terms of sustainable economic development. That is why this approach has been used as a reference by the European Commission in its Action Plan for Sustainable Finance published in March 2018.

The main principles of this article are fourfold: (i) the obligation to integrate ESG factors, previously limited to asset management companies, has been reinforced and extended to institutional investors; **(ii) climate is at the core of ESG, as the article advocates focusing on environmental factors as well as financial climate-related risks**; (iii) it encourages investors to consider the impact of their investment on ESG factors as well as the impact on the investment of ESG factors; and (iv) investors choose which analysis tools are better suited to their investment strategy, allowing the financial sector to develop best practices and relevant methodological tools (i.e. carbon metrics; impact drivers; scoring systems...).

Therefore, "article 173-VI drives a movement toward improving the climate-related data required by financial players. This data will enhance the perception of the risks investors are exposed to, thereby **contributing to correcting the risk premium associated with the assets**" (Ian Cochran (I4CE)).

All in all, the ESG approach to investment aims to both reduce the ESG risk of an investor's portfolio and reduce the ESG impact of this portfolio. It therefore encourages investors to divest from carbon-intensive assets and increase their exposure to green solutions and contribute to the ecological transition and, ultimately, to achieve a reduction target aligned with the 2°C pathway.

## Impact investing as a catalyst to implement the SDGs

At the cutting edge of investment management and economic development, the impact investing industry has emerged in the early 2000s, mainly led by the UK (the first country to set up a social stock exchange) and rapidly followed by Canada in 2013, while the terminology "impact investing" was used for the first time in 2007. **Impact investing goes a step further by actively seeking investments that can create a positive impact.** The Inter-American Development Bank (IDB) defines impact investments as investments which "have an explicit and inherent intent at a startup to address environment or social issues, as well as a business model with a structure dedicated to achieve both impact and financial returns".

The ecosystem of impact investors includes foundations, pension funds, impact investing funds, institutional investors and rich individuals.

Beneficiaries of this capital are both NGOs and for-profit companies, as long as they fulfill the criteria required by the investors.

The industry is growing extremely fast: in the GIIN's 2017 Annual Impact Investor Survey, 208 respondents reported that they were managing **USD 114 billion in impact investing assets**. Impact investors typically use the whole range of financial methods, from below-market to market-rate investments and across all types of asset classes (i.e. grant support; fixed income; guarantees; subordinated loan; public and private equity – whose definitions are listed here below).


Seeking not only a financial return, **impact investors pay equal attention to the environmental and/or social impact** of their enterprise, though **such impact it is currently still difficult to assess**. That is why relevant metrics are under development in order to compare investment projects and help impact investors make wiser decisions, especially considering the fact impact investors are more concerned with financial stability and return of capital over a longer term period than traditional investors. Nevertheless, **measuring impact requires very complex methodologies in all sectors covering the SDGs**: as of today, relevant metrics have been developed to measure climate impact (i.e. carbon dioxide equivalent; calculation of avoided greenhouse gas emissions) or environmental impact (i.e. percent recycled materials; greenhouse gas emissions of energy generated) but as far as a lot of sectors are concerned (biodiversity, education), measurements remain mainly qualitative.

For instance, Natixis has developed an impact-based toolkit for issuers and investors, based on the idea that attempting to embrace the 17 SDGs in the design of an equity investment solution has strong chances to dilute the targeting and purpose of such product. On the contrary, Natixis proposed to focus on a cluster of few interconnected and tangible goals in their products and results, as some SDGs appear to be key enablers to the achievement of other SDGs by laying the right empowering foundations (see their toolkit online).

In this context, several issues need to be tackled so that impact investing can gain broader attention: first, there is a need for a **more efficient financial intermediation between capital suppliers and sustainable projects holders** so as to tackle the liquidity gap of many impact investment projects. Better disclosure and more specialized structures in this field could considerably accelerate investment. **Proper assessment tools** of impact investment need to be developed, along with best practices in the industry. **Better suited financial regulations** could also make impact investing less burdensome on some financial actors.

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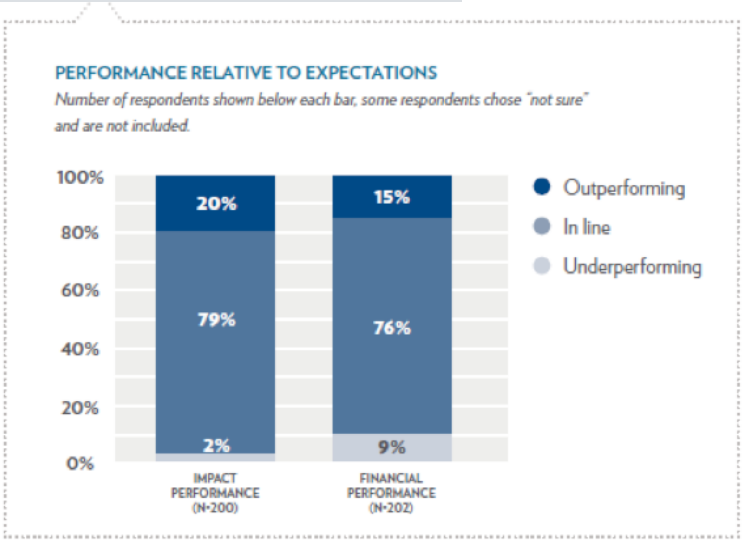
## Annex 1 – A few key stakeholders in the impact investing ecosystem

- **The Global Impact Investing Network (GIIN)** (USA): A nonprofit organization dedicated to increasing the scale and effectiveness of impact investing around the world.

- **Blue Orchard Finance** (Netherlands): Founded in 2001 by initiative of the UN as the first commercial manager of microfinance debt investments worldwide. Up until now, it has invested USD 4.7 billion in 350 institutions across 70 countries, providing access to financial and related services to over 35 million low-income individuals.

- **The UN Sustainable Development Solutions Network** (SDSN), operating since 2012 under the auspices of the UN Secretary General and mobilizing global scientific and technological expertise to promote practical solutions for sustainable development. A notable example is the work led by Dr. Guido Schmidt-Traub to help fight AIDS, Tuberculosis and Malaria.

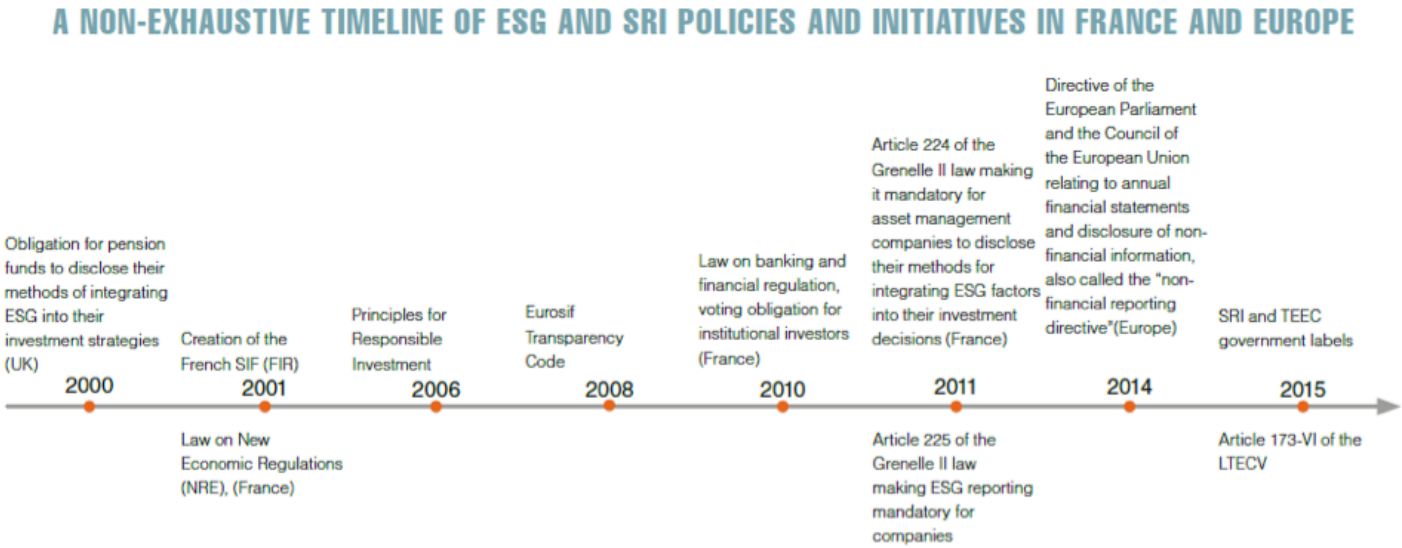



*Source: Global Impact Investing Network, "Impact Investing – A guide to this dynamic market" (available online).*

## Annex 2 – ESG and SRI policies and initiatives in France and Europe

Article 173 of the French Energy Transition Law came into force on 1 January 2016. It strengthens mandatory carbon disclosure requirements for listed companies and introduces carbon reporting for institutional investors, defined as asset owners and investment managers.

Source: French SIF, "Article 173-VI: Understanding the French regulation on investor climate reporting", October 2016




## Annex 3 – References


- The **Global Impact Investing Network (GIIN)**
- **Impact Investment / UNDP**
- **Investopedia**
- **Stanford Innovation Review,** "Strengthening the impact investing movement" (March 2017)
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- **French Securities Markets Authority**, « AMF report on socially responsible investment in collective investment schemes » (December 2017)