



GOING GREEN

Considerations for Green Bond Issuers

BY MARK T. KIM

The green bond market has grown dramatically over the past few years, and many public-sector issuers are considering whether they should be “going green” by issuing green bonds. In the simplest terms, green bonds raise capital for projects that have environmental benefits. There is no universally accepted definition of a green bond, however, and in many respects, green bonds are no different than the traditional bonds that many state and local governments and non-profits issue to fund their capital programs. There has been confusion in this market because issuers must decide for themselves whether to label their bonds green, and investors have their own investment guidelines on green bonds. In addition, there is no body that sets standards to establish uniform criteria for monitoring and reporting on the use of green bond proceeds and environmental outcomes, which only contributes to the confusion. This article presents a brief history of the green bond market, followed by a cost-benefit analysis of issuing green bonds and a summary of current best practices.

MARKET HISTORY

The green bond market began in Europe with multilateral development banks and governments. The European Investment Bank is generally credited with pioneering the first type of green bond with its Climate Awareness Bond in 2007, which was followed by the World Bank’s inaugural Green Bond in 2008. Issuance volume in the green bond market began to grow significantly in 2013 with the first corporate green bond, by the French electric utility company EDF, and the first municipal green bond in the United States, by the Commonwealth of Massachusetts. By 2014, green bond issuance totaled approximately \$36.6 billion, including increased momentum with U.S. municipal issuers, which accounted for \$2.8 billion of the total. (See Exhibit 1.) The pace of green bond issuance has slowed in 2015 — to approximately \$25.6 billion as of September — but is projected to be similar in total volume to 2014’s record-setting year.

COST-BENEFIT ANALYSIS

Issuers should carefully consider the potential risks and rewards of issuing green bonds by undertaking a cost-benefit

analysis. The most commonly cited potential benefits of issuing green bonds are investor diversification, public relations, and the cost of funds.

Investor Diversification. Green bonds may present an opportunity for issuers to diversify their investor base and improve market access. In 2005, the United Nations convened a group of the world’s largest institutional investors to develop what are now known as the Principles for Responsible Investment (PRI). Today, there are more than 1,300 PRI signatories with more than \$59 trillion in total assets under management. All have publicly endorsed this investment strategy: “Responsible investment is an approach to investment that explicitly acknowledges the relevance to the investor of environmental, social, and governance (ESG) factors, and the long-term health and stability of the market as a whole.”¹ Green bonds may attract a broader range of institutional investors that are committed to responsible investment as an asset class and might not have been interested in the traditional bonds of a particular issuer otherwise.

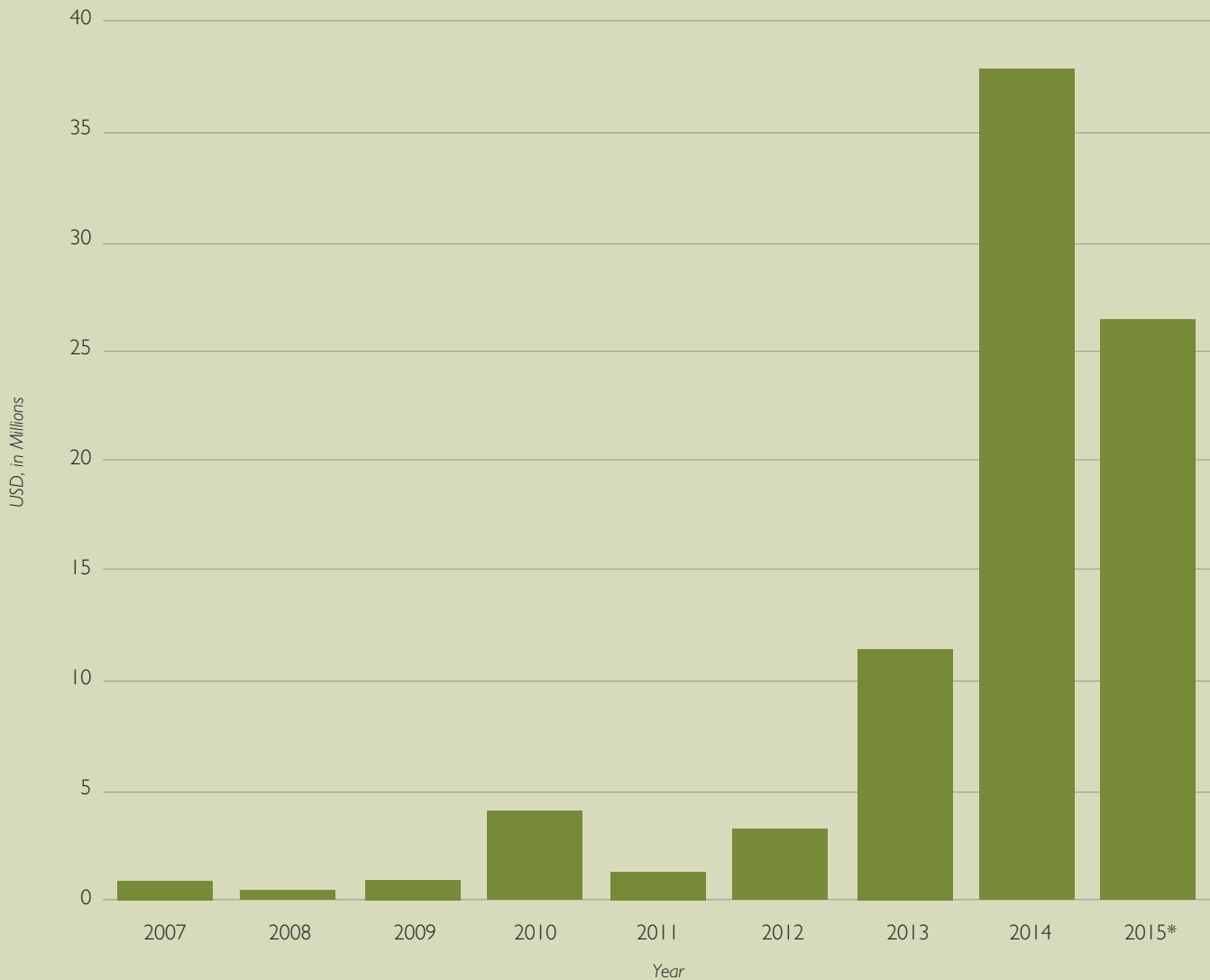
Public Relations. Issuers can use green bonds to enhance public relations with their stakeholders by marketing themselves as environmentally conscious, sustainable, and responsible. A number of municipal issuers have used their green bond issues to effectively highlight their environmental

credentials, particularly in the water, power, and transportation sectors.

Cost of Funds. Green bonds may provide issuers with pricing benefits (i.e., lower yields) over traditional bonds. A recent news article cited a research report from Barclays Capital concluding that green bonds benefit by as much as 20 basis points over the pricing of traditional bonds.² To date, however, there has been little empirical evidence to suggest that municipal green bonds offer any pricing benefits over traditional municipal bonds. The best argument in support of a pricing benefit for green bonds over traditional bonds is that over time, increased investor demand is likely to contribute to better pricing for the issuer. Anecdotal evidence supports this

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Exhibit I: Green Bond Issuance Since Inception



*as of September 2015

Source: Climate Bonds Initiative, Year 2014 Green Bonds Final Report.

argument, as many municipal green bond issues have reportedly been over-subscribed with investor demand.

Issuers must weigh the potential benefits of issuing green bonds against the potential costs, which include costs of issuance, administrative burden, and reputational risk.

Costs of Issuance. There are several evolving standards and criteria for issuing green bonds, many of which recommend or require the issuer to pay for an independent “second party” opinion of its green bond selection

criteria and project evaluation methodology, or a post-issuance “third party” assurance (e.g., audit or attestation) on the use of green bond proceeds and environmental outcomes. The costs for these types of services are in addition to the usual costs of issuance and would make green bonds more expensive to issue than traditional bonds.

Administrative Burden. A second potential cost for issuers is the ongoing burden on staff to administer a green bond

issuance program, which may include compliance-related activities such as monitoring and reporting on the use of proceeds and environmental outcomes. Issuers should evaluate the capacity of their financial systems and staff resources to separately manage and track green bond proceeds, and to collect data and evaluate environmental outcomes.

Reputational Risk. Given the lack of universally accepted standards and criteria, issuers may subject themselves to reputational risk and public criticism for issuing green bonds for non-green projects. The term “green washing” has been coined to describe issuers that have been accused of labeling a bond green to finance projects with questionable environmental benefits.³ Issuers should be careful in assessing the reputational risk associated with green washing and exercise caution prior to labeling a bond green without undertaking sufficient due diligence.

By 2014, green bond issuance totaled approximately \$36.6 billion, including increased momentum with U.S. municipal issuers, which accounted for \$2.8 billion of the total.

GREEN BOND PRINCIPLES

There are several evolving standards and criteria for the issuance of green bonds. These include the Green Bond Principles (GBP), which are a set of four voluntary process guidelines for the issuance of green bonds.⁴ The GBP are not mandatory, and there is no enforcement mechanism for non-compliance. However, they do provide a high-level definition of green bonds

as “any type of bond instruments where the proceeds will be exclusively applied to finance or refinance in part or in full new and/or existing eligible green bond projects and which follows the four green bond principles: 1) use of proceeds; 2) project evaluation; 3) management of proceeds; and 4) monitoring and reporting.⁵ The GBP represent the current best practice in issuing green bonds.

Use of Proceeds. The GBP explicitly recognize eight categories of green bonds and recommend that issuers

Case Study: DC Water’s Green Bond Issue

In July 2014, the District of Columbia Water and Sewer Authority (DC Water) issued a \$350 million green bond to finance a portion of the DC Clean Rivers Project, a federally mandated water quality improvement program designed to reduce combined sewer overflows into the District’s waterways. DC Water undertook a cost-benefit analysis and determined that it had the systems and controls in place, as well as the staff resources, to effectively manage the administrative burden of issuing a green bond. DC Water followed best practices and retained an independent sustainability consultant to provide a “second party” opinion on the environmental benefits of the project, which was the first green bond issued in the US to offer investors this form of assurance.

The agency also made a commitment to its investors to report annually on the use and management of green bond proceeds, as well as on certain environmental, social and governance

performance indicators, and criteria. In DC Water’s judgment, the additional costs related to the green bond were modest and reasonable, mitigated any potential reputational risk of green washing, and offered a unique opportunity for DC Water to highlight its environmental accomplishments and credentials to its public stakeholders.

This sale marked DC Water’s inaugural green bond and was the largest municipal green bond to have been issued at that time. The sale was well received by investors, with more than \$1 billion in orders for the \$300 million bonds initially offered. Nearly \$100 million in orders came from first-time investors in DC Water who identified themselves with socially responsible investment funds. Due to strong investor demand, DC Water upsized the transaction to \$350 million and lowered the yield by 15 basis points from the original offering price.

DC Water is currently structuring its second green bond issue scheduled for the 4th quarter of 2015.

consider them as a guide to eligible green bond projects:

- Renewable Energy
- Energy Efficiency
- Sustainable Waste Management
- Sustainable Land Use
- Biodiversity Conservation
- Clean Transportation
- Sustainable Water Management
- Climate Change Adaptation

The most commonly cited potential benefits of issuing green bonds are investor diversification, public relations, and the cost of funds.

Project Evaluation. The GBP recommend that issuers establish a transparent process to determine how the project qualifies in one of the eight categories of green bonds identified above and to identify the standards and criteria used to evaluate project eligibility. The GBP also recommend that issuers state the environmental sustainability objectives of the project.

Management of Proceeds. The GBP recommend that issuers segregate their green bond proceeds into a separately managed account or in such a manner that their use can be tracked and monitored appropriately. The temporary investment of green bond proceeds pending disbursement should adhere to the issuer's investment policy and guidelines.



Monitoring and Reporting. The GBP recommend that issuers report at least annually on the use and management of green bond proceeds as well as the expected and achieved environmentally sustainable outcomes of the project. It is further recommended that issuers use both qualitative and quantitative performance indicators, as well as external assurance such as second-party opinions and third-party reviews.

CONCLUSIONS

The green bond market has experienced rapid growth and may represent an opportunity for issuers to access a new pool of investors, enhance their public image, and achieve lower cost of funds over traditional bonds. However, the lack of universally accepted standards and criteria governing this market pose certain risks and challenges, which are often more tangible than the potential benefits of issuing green bonds at the present time. Issuers may mitigate these risks, in part, by adopting current best practices in following the Green Bond Principles. As best practices continues to evolve, they will likely lead to lower transaction costs for issuers and greater demand by investors, which should result in a better price for green bonds over traditional bonds. Until that time, issuers should exercise caution and due diligence in labeling their bonds green and should take a rigorous approach to the use and management of proceeds and to the monitoring and reporting expectations of green bond investors. ■

Notes

1. Principles for Responsible Investment, "About the PRI Initiative." (<http://www.unpri.org/about-pri/about-pri/>)
2. Tracy Alloway, "Investors Are Paying Extra for Environmentally Friendly Bonds, Barclays Says," Bloomberg Business, September 18, 2015.
3. There have been numerous articles published on green washing. See Mike Cherney, "'Green Bonds' for a Parking Garage?" The Wall Street Journal, March 12, 2015.
4. The Green Bond Principles are administered by the International Capital Market Association. (<http://www.icmagroup.org>)
5. Green Bond Principles, 2015, "Voluntary Process Guidelines for Issuing Green Bonds," March 27, 2015.

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