GFOA White Paper: Green Bonds

Green bond issuance generated significant attention beginning 2014 and has garnered more attention as the market expanded in subsequent years. However, this emerging market faces inconsistent expectations among potential green bond investors, and it is not yet evident that green bond designation results in a direct financial benefit to issuers. As the market grows, issuers should expect standards to continue to develop.

As with any financing tool, it is important that issuers understand costs, risks and benefits before entering into a transaction. Note that all existing debt management best practices continue to apply to bonds issued for green projects. This document is intended to inform GFOA members of important considerations related to the evolving market for green bonds.

Background

Until 2013, "green bond" designations had been mainly used by international financial institutions such as the World Bank's environmental department, which began issuing small amounts of green bonds in 2008. In 2013, the World Bank's private sector arm, the International Finance Corporation, issued a $1 billion green bond, and the French energy group EDF issued $1.9 billion in green bonds. Although there is not a generally accepted market definition of a green project, many green bond issues have financed projects with characteristics that broadly fall into several categories, including:

1. Environmental Benefits:
    a. Clean power
    b. Clean transportation
    c. Clean/drinking water
2. Climate Adaptation, Mitigation or Resilience:
    a. Renewable Energy
    b. Energy Efficiency
3. Sustainability and Conservation:
    a. Waste Management
    b. Land Use and Reclamation

These categories include a wide range of projects for which many governments already issue bonds, so in the absence of industry acknowledged standards, issuers have self-designated their issues as green bonds. Additional guidance for investor evaluation of green bonds have been published in 2016 and 2017 by Moody's, Fitch and Standard & Poor's and have offered evaluation criteria to varying degrees on the basis of their use of proceeds, evaluation and selection of environmental projects, management of proceeds and reporting and disclosure practices.

Issuance of green bonds by state and local governments has commenced and is continuing, although the number of tax-exempt green bond issuers remains a very small ratio of total tax-exempt issuers, and approximately a tenth of these are from the higher education sector. The first green municipal bond was issued by the State of Massachusetts in June 2013. In October 2013, Gothenburg (Sweden) issued the first green bond by a city. 2014 saw green bond issuance by the State of California the Province of Ontario, DC Water, New York State, the City of Johannesburg (South Africa) and others.

Green bond annual issuance globally has increased over the past three years from $43 billion to $132 billion. Annual issuance of green bonds by U.S. states and localities and for higher education has increased from $3.8 billion to $10.1 billion in the same time period.

Considerations

Green bonds may seem appealing for your project or bond issue, but it is important for an issuer to understand that opinions vary and the issuer should decide what is right for your organization. This decision should be made with the participation of your Bond Counsel and municipal advisor to ensure compliance with pre-existing legal regulations and securities best practices. Here are some areas to consider as you examine if the green bond designation is the right answer for your entity:

Project Eligibility. Issuers are responsible for self-labeling bonds (and bond funded projects) as *green*. There is no universal agreement regarding a specific project scope to best qualify for funding by green bonds. Investor expectations vary by issue and issuer, and continue to evolve as the market and standards mature. GFOA members are encouraged to examine the Green Bond Principles (GBP), a voluntary process guideline that recommends transparency and disclosure and promotes integrity in the development of the green bond market by clarifying the approach for issuance of a green bond. Additional sets of standards are also currently under development. As of yet, there is no universally accepted definition and issuers should be aware that standards developed by differing groups may be more lenient or more rigorous than others.

Use of Proceeds. As green bonds are generally associated with a use of proceeds verification and reporting requirement, issuers should consider their ability to separately manage the use of green bond proceeds from non-green bond proceeds. This includes adequate monitoring and reporting capabilities on the use of those proceeds for the specified green projects. This is an area of concern for green bond investors, who may be required to monitor compliance with specific green investment objectives.

Independent Opinion/Attestation. Many green bond issuers have attained an opinion or attestation from an independent entity confirming that the funded projects meet “green” qualifications. The quality and depth of review and attestation can be inconsistent, and there appears to be a difference of opinion among investors regarding the value of such an opinion. Independent attestation will represent an increased cost of issuance, which may not be offset by reduced interest cost as described above. GFOA members need to consider whether the self-labeling or independent opinion approach is the best choice for their particular transaction.

Ongoing Reporting Obligations. Beyond Securities Exchange Commission (SEC) Rule15c2-12 regarding continuing disclosure requirements, there is no consistent expectation among investors regarding additional reporting obligations for green bonds. While some investors simply want to see the word *green* in the title, mission-driven investors may expect ongoing reporting of project expenditures or outcomes demonstrating specific environmental achievement. Issuers should consider developing internal standards – what information will be gathered and provided, who will be responsible for assembling that information and how will it be provided to the market. MSRB’s Electronic Municipal Market Access system (EMMA) or an issuer’s website or investor communications page are examples of market communication platforms.

Outcome or Impact Analysis and Quantification. Some green bond investors and advocacy groups have indicated a preference for ongoing reporting of outcome or impact statistics. Before making additional reporting commitments, issuers considering issuance of green bonds should carefully consider whether adequate resources and staffing are available to meet this voluntary obligation.

Pricing Benefit: While headlines may indicate a green bond sale being oversubscribed, pricing data is limited and complicated (many market factors contribute to bond pricing), and results currently appear inconclusive. Issuers should be aware that a green bond designation is not a vehicle to achieve better-than-normal bond pricing at this time.

Other Considerations. Some market participants have questioned the appropriateness of providing special and additional protections for green bond investors beyond the extensive investor projections of the traditional tax-exempt municipal bond market. The lack of definitions and standards in the face of rapid growth in the issuance of green bonds have drawn criticism of "green-washing" in which issuers designate an issue green with little or no supporting documentation. Also, issuers may have existing green infrastructure initiatives, CIP/financial planning considerations, debt policies and/or other green energy action plans. Care should be taken to ensure that green bond issuance remains consistent with these existing plans and policies and to ensure that staff (some of whom may be non-financial representatives) and elected officials are prepared to share increased responsibility for meeting specialized requirements of a green bond program.

References and Educational Materials

1. Green Bond Principles
2. Climate Bonds Initiative
3. SEC Rule 15c2-12