Verifying Green Bonds

ACROSS THE GLOBE, IMPLEMENTING THE PARIS CLIMATE AGREEMENT is expected to cost more than US$12 trillion over 25 years.

So it's not surprising that much of the conversation since the agreement was finalized in December has been about climate finance. And one of the big topics in climate finance—particularly among city leaders—is "green bonds."

But what exactly are green bonds, and why should local authorities care about them? Here's a brief explanation of the major issues.

WHAT IS A GREEN BOND?

A green bond is a type of debt instrument much like any other bond—except that the proceeds must be earmarked for projects that produce a positive environmental impact.

The first bonds marketed this way were issued by the European Investment Bank in 2007 and World Bank in 2008. Since then, other development banks, corporations, and governments have joined the trend. According to the Climate Bonds Initiative, a research group that tracks the market, total green-bond issuances shot up from US$3 billion in 2012 to about US$42 billion in 2015.

Local authorities represent a growing slice of this market. They see green bonds as one tool that could help pay for renewable energy, transit systems, and water infrastructure, among other things.

The U. S. state of Massachusetts sold the first municipal green bond in June of 2013, followed a few months later by the city of Gothenburg, Sweden. Other recent issuers include the city of Johannesburg; the transit authorities of New York City, Seattle, and London; and the water authority of Washington, DC.

This article originally appeared at Citiscope.org. Citiscope is a nonprofit news outlet that covers innovations in cities around the world. More at Citiscope.org.

ARE GREEN BONDS ANY DIFFERENT THAN OTHER MUNICIPAL BONDS?

Not really. The mechanics work the same as any other municipal bond issuance. The main difference is the environmental aims of whatever the city is using the bond proceeds to pay for.

In addition, green-bond issuers face some additional paperwork—essentially to prove to investors that their money is actually being used to benefit the environment.

To some degree, green bonds are a marketing tool. Labeling a bond that will pay for subway repairs as "green" makes it more appealing to investors. "The reality is a lot of cities are issuing green bonds, they're just not calling them that," says Jeremy Gorelick, who teaches municipal finance at Johns Hopkins University in the U.S. city of Baltimore.

> "If I called my fire truck 'green,' investors might raise an eyebrow," Germán says. "But it's a two-sided market, so there's some check and balance. An issuer will raise that money only if an investor believes it's really for a green purpose."

That may be true in advanced economies such as the United States, where a mature municipal-bond market has been functioning for more than a century. In the developing world, most cities are unable to issue bonds at all, and for a variety of reasons. In many countries, cities need to obtain legal authority from their national governments to issue a bond in the first place. They also have a lot of work to do in terms of establishing creditworthiness.

Gorelick, who is advising the city of Dakar, Senegal, on its efforts to issue its first municipal bond, recommends that cities in this situation not aim for the bond market right away. He says they can first try borrowing from central governments or their related municipal development

Green bonds funded the DC Water Sewer Authority Clean Rivers Project. Credit: © Dennis Tarnay, Jr. / Alamy Stock Photo

funds before approaching development finance institutions for concessionary loans or commercial banks for market-rate debt. The idea is to build creditworthiness and the sort of transparent accounting that bond investors active in debt capital markets will demand.

WHY ARE CITIES SO INTERESTED IN GREEN BONDS?

There are many reasons. The key one is that investors really want green bonds in their portfolios right now. As a result, municipal issuers have seen sales of green bonds "oversubscribed"—a good problem for a city to have.

When Gothenburg issued its first green bonds in 2013, "we didn't know if there would be any interest from investors," says Magnus Borelius, Gothenburg's head of treasury. Within 25 minutes, investors had placed €1.25 billion worth of orders—many times more than expected—and Gothenburg had to begin turning them away. "We were overwhelmed," Borelius says.

Cities benefit from strong investor demand in a number of ways. Most important, it means they can attract new kinds of investors, diversifying the pool of people and institutions with an interest in their city. "It's good to have a lot of investors know you have access to capital," Borelius says. Since issuing green bonds, he adds, "we've had increased contact with investors—they're more interested in the city, and they're coming to visit us."

Strong investor demand "puts the issuer in an advantageous position," says Lourdes Germán, a municipal finance expert with the Lincoln Institute of Land Policy. Local authorities can use their leverage to increase the size of their offering, demand a longer payback period, or seek better pricing. While some cities have reported getting more favorable pricing on green bonds, Germán says issuers shouldn't count on it. "It remains murky whether calling it 'green' gets better pricing," she says.

WHAT'S IN IT FOR INVESTORS?

A growing number of investors want to see their money going toward environmentally sustainable projects. Some are motivated by the fight against climate change; others are simply hedging climate risks in their portfolios.

The result is that more pension funds and private-asset managers these days have some kind of mandate to think green. For example, last month, the Swedish public pension fund AP2 said it was allocating 1 percent of its €32 billion portfolio to green bonds. When you're talking about huge institutional investors, commitments like this add up quickly.

On top of that, municipal bonds, at least in established markets like the U.S., are generally viewed as safe investments. So green bonds issued by cities are particularly desirable. "Institutional investors have a fiduciary duty and won't invest in a product that won't deliver a return," says Justine Leigh-Bell, a senior manager at the Climate Bonds Initiative. "We have here an investment-grade product by blue-chip issuers where the risk is low."

HOW DO YOU KNOW IF A BOND IS "GREEN"?

There are no hard rules around that—which is a concern for both investors and environmentalists. However, the market for green bonds is evolving quickly, and some voluntary standards are emerging for issuers.

One, developed largely by large banks through the International Capital Market Association, is called the Green Bond Principles. Another was developed through the Climate Bonds Initiative and is known as the Climate Bonds Standard. The People's Bank of China also recently released its own guidelines on green bonds.

Nobody has to use these standards, but there's a strong push in the direction of doing so. "If I called my fire truck 'green,' investors might raise an eyebrow," Germán says. "But it's a two-sided market, so there's some check and balance. An issuer will raise that money only if an investor believes it's really for a green purpose."

A growing number of municipal issuers are seeking out third-party opinions to validate their bonds' "greenness." That's what Gothenburg does. The Swedish city also has created a "green bond framework" to be transparent with investors about what the city considers "green" and how it selects projects.

"It's still early days in this market," says Skye d'Almeida, who manages the sustainable infrastructure finance network for the C40 Cities Climate Leadership Group. "So it's very important to avoid any 'greenwashing' scandals where cities say they issued a green bond and investors find out down the track that it wasn't green. That would erode confidence in the market. So having some independent party verify and being very transparent about the use of the proceeds is something cities should be prepared to do."

DOES IT CREATE A LOT OF EXTRA WORK OR COST FOR THE CITY TO ISSUE A GREEN BOND?

Some. Leigh-Bell puts the cost of an independent review at between US$10,000 andUS$50,000, depending on who is doing the review and other factors. That's a rounding error on deals that are often valued in the hundreds of millions of dollars.

Issuing green bonds can create extra work for city staff. Ahead of an issuance, there's the need to scour the city's capital investment plans for projects that qualify as green. Afterward, there's work involved in tracking the use of proceeds and reporting that information to investors. According to d'Almeida, these jobs have the positive side effect of forcing people to work across their silos—finance staff must collaborate with transportation or environmental staff, for instance.

Borelius says that has been the case in Gothenburg. "The first question people ask me about green bonds is, 'How much extra work is it?'" he says. "If you don't put treasury people and sustainability people at the same table, it will be a lot of extra work. But if you're issuing a green bond, you should have that in place."

Johannesburg Mayor Mpho Parks Tau agrees that mobilizing around green bonds has paid organizational dividends. Asked recently if labeling bonds "green" is mostly about marketing, the mayor responded that the exercise has been useful for aligning local government as an institution around his environmental agenda. "We are able to say to the institution, actually, the bulk of our capital program is going to be about sustainability."

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