Going Green: Why Municipal Bond Issuers Should Consider Green Bonds

Green bonds can attract new investors and establish your municipality as environmentally responsible. Here's what you need to know about the green bond market.

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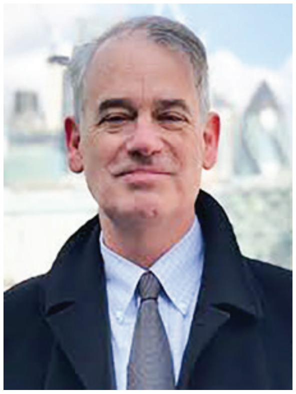

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Sean Kidney
CEO
Climate Bonds Initiative

In the last two years, about $15 billion in green municipal bonds were issued, according to the Climate Bonds Initiative (CBI).[1] Demand for green bonds is growing, driven by mutual funds and separately managed accounts that are focused on investing in green bonds and other projects that have a positive social impact (commonly known as “Socially Responsible Investing” that focuses on environmental, social, and governance ESG factors).

Many municipalities are interested in issuing green bonds but have misconceptions about the green bond market. Municipalities are concerned about perceived higher costs and more burdensome compliance and reporting, both to determine if their bonds “qualify” for green bond labeling and to evaluate environmental outcomes of green bond-financed projects.

However, success stories about transactions by about a dozen large bond issuers – including the Commonwealth of Massachusetts Clean Water Trust, which had strong retail investor demand and was oversubscribed, New York’s Metropolitan Transportation Authority, the NYC Housing Development Corporation, and others – have piqued the interest of other municipalities.

“There is a significant opportunity to scale up green bond sales by U.S. municipal issuers by raising awareness of the benefits of green bond financing for issuers and reducing the transaction costs for green bond sales,” said Sean Kidney, CEO of the Climate Bonds Initiative, a London-based non-governmental organization that develops standards for green bonds and certified climate bonds.

The Growth of Green Bonds

Municipal green bonds are issued to finance projects that advance environmentally sustainable goals and policies. The issuer must commit to using 100% of the bond revenues to fund initiatives such as energy-efficient buildings, renewable energy, clean water and sewer projects, and low-carbon transportation.

Green bonds have been around for more than a decade, with the first green bond generally attributed to the European Investment Bank with its Climate Awareness Bond in 2007. In the U.S., the Commonwealth of Massachusetts became the first U.S. municipal issuer to sell a green bond in 2013.

In addition to the opportunity to tap new pools of capital, selling green bonds provides an opportunity for governments to highlight how their infrastructure plans can deliver clean water, reduce pollution and mitigate or adapt to climate change. The resulting public relations boost can help build resident and taxpayer support for the community’s overall capital plan.

To demonstrate their support for continued growth in the market, some issuers are embracing the “Green Bonds Pledge,” which commits them to finance infrastructure and capital projects that are designed to meet the challenges of climate change with green bonds.[2] Former California Gov. Jerry Brown and Treasurer John Chiang helped develop the Pledge, and a growing roster of issuers are joining the Golden State.

While the $11 billion issuance of green bonds in 2017 alone was certainly impressive, green bond issuance volume is heavily concentrated in a few states. In 2017, New York issued $4.5 billion in green bonds and California issued $4.32 billion, according to CBI. In December 2017, the NY Metropolitan Transit Authority issued a $2.92 billion green bond,

[1] https://www.climatebonds.net/resources/press-releases/2018/01/record-11bn-green-municipal-bonds-2017-across-us
[2] https://www.treasurer.ca.gov/news/releases/2018/20180807/44.pdf

"Green bond investors want to know that issuers are following through with the capital plans."

Laura Levenstein
CRO
Build America Mutual

Who's Going Green?

Select BAM GreenStar Verified Green Bond Transactions

Issuer	State	Par Issued	Purpose
City of Centerton	AR	$15,985,000	Water and Sewer Capacity Improvements
Hayward Unified School District	CA	$20,000,000	Energy Efficiency Upgrades
Placer County Public Financing Authority	CA	$33,985,000	PACE Energy Efficiency Upgrades
Stockton Public Financing Authority	CA	$140,385,000	Water Supply System Improvements
City of Bedford	IN	$12,945,000	Water and Sewer System Expansion and Upgrades
City of Santa Fe	NM	$13,550,000	Wastewater Treatment Plant Replacement
City of Lima	OH	$7,535,000	Sewer System Capacity Upgrades
South Middleton Township Municipal Authority	PA	$9,130,000	Sewer System Expansion and Upgrades
Schertz/Seguin Local Government Corporation	TX	$19,045,000	Water Supply System Expansion and Upgrades
Upper Trinity Regional Water District	TX	$28,390,000	Wastewater Treatment System Expansion and Upgrades

making it the leading municipal green issuer to date, and the sixth largest green bond issuer globally during 2017.

That means there's plenty of room for growth as other municipalities become more aware of and educated about the green bond market.

Two California issuers who sold green bonds in 2018 – the Placer County Public Financing Authority and the Stockton Public Financing Authority – illustrate the opportunity for small- and mid-sized cities and counties to become more active in the green bond market. The Placer County issue raised $35 million for its mPOWER Placer PACE program to finance energy efficiency upgrades to homes and buildings in the county, while the Stockton transaction raised $140 million to refund debt sold primarily to finance a project to improve the sustainability of the city's water supply. Both issuers participated in the BAM GreenStar program that provides a third-party verification of a bond's alignment with the International Capital Market's Association's Green Bond Principles.

What's Hampering Growth

Investors may be interested in going green, but the supply of green municipal bonds hasn't kept up with demand. According to the Brookings Institution, only 2,083 green bonds were issued from 2010 to 2016 compared to 643,299 ordinary bonds.[3] There is a shortage of bonds labeled as green and some confusion about what a green bond is—and isn't.

[3] https://www.brookings.edu/wp-content/uploads/2018/07/Wurgler-J.-et-al..pdf

"BAM was created to help our issuer members access the capital markets efficiently and transparently. BAM GreenStar is a natural extension of that mission."

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CEO
Build America Mutual

Part of the shortage of green bonds is that a significant number of bonds that fund qualifying projects are not labeled as green: Some estimates place the gap at as much as 15% of the current market new-issue volume, or $50 billion per year. In fact, most environmentally friendly projects are still financed by ordinary bonds.

Another reason that municipalities have not issued more green bonds is that although there's wide acceptance of the idea of green bonds, there isn't a universally accepted process for determining whether or not a municipal bond is green.

The organizations that have set principles and voluntary process guidelines for green bonds include the CBI and the ICMA, with its Green Bond Principles. While these guidelines do provide transparency and disclosure to the market, there is limited enforcement for non-compliance, although some third-party verifiers have required ongoing disclosure as a condition of their assessment.

"Green bond investors want to be sure that the issuers are following through with the capital plan they initially laid out during the underwriting process," said Laura Levenstein, Chief Risk Officer of Build America Mutual, which launched the BAM GreenStar green bond assessment program in October 2018. "BAM GreenStar issuers agree to provide annual updates on the construction status of their projects until they are put in service, and BAM reserves the right to remove the BAM GreenStar designation if the proceeds are ultimately spent on projects that are ineligible for green bond financing."

Some issuers have chosen to "self-label" their green bonds, which can raise legal or reputational risks if the description is later shown to have been applied improperly. Others have hired a third party to verify the green status, which can increase the costs of issuance for the bond issue.

Another challenge for issuers and investors is that the green market is not as liquid as it could be. However, as more labeled bonds become available, liquidity will improve and positively impact pricing on the primary and secondary markets. Over time, increased demand for green bonds may contribute to better pricing.

Strategies to Overcome the Hurdles

Municipalities who consider selling green bonds early in the planning process for their capital plans are finding that it does not necessarily take significantly more time and effort than selling an ordinary bond: The approval process is similar, and while a green bond may require more disclosure, the information is generally available within the government, so the key is communicating the needs across multiple departments.

Green municipal bonds can offer investor diversity. Since the universe of investors likely to invest in municipal bonds is discrete from the universe interested in green bonds, issuing green bonds allows municipalities to tap into a wider investor base interested in responsible investments that may not have been interested in traditional bonds. When the District of Columbia Water and Sewer Authority issued a $350 million green bond to finance a portion of the DC Clean Rivers Project, almost $100 million in orders came from first-time investors in D.C. That additional source of demand for bonds can also help to smooth out market volatility.

BAM GreenStar helps municipalities access the benefits of the green bond market. Available at no additional cost to issuers that utilize BAM insurance, BAM's third-party green bond review program was specifically designed for U.S. municipal bonds and identifies transactions that fund capital plans that align with the ICMA's Green Bond Principles. BAM has built this verification into its initial underwriting and annual review processes.

For issuers whose projects can demonstrate that they support a significant reduction in carbon emissions or help their communities adapt to the impacts of climate change, BAM has also been approved as a verifier for Certified Climate Bonds by CBI.

"BAM was created to help our issuer members access the capital markets efficiently and transparently. The BAM Green Star initiative to identify qualified green bonds and Certified Climate Bonds is a natural extension of that mission," said BAM Chief Executive Officer Seán W. McCarthy.

Municipal green bonds can give issuers access to a pool of investors who would not typically invest in municipal bonds as well as a public relations boost. As the green bond market grows, the financial benefits will also improve. By partnering with BAM, municipalities receive a third-party review at no additional cost while ensuring that the bond conforms to industry standards.

About Build America Mutual

BAM is a mutual bond insurance company operated for the benefit of its members – the cities, states and other municipal entities that use BAM's financial guaranty to lower their cost of borrowing. BAM is the National League of Cities' preferred provider of bond insurance. Through March 31, 2019, BAM has insured more than $50 billion of municipal securities for more than 3,000 municipal issuers nationwide.

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