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The New Gold Rush for Green Bonds.

Investors are lining up to buy green bonds. Can they survive the hype.

Hanging on the wall just outside Bryan Kidney's office in Lawrence, Kan., is the framed first page of a bond offering statement. Unlike most — or really, any — bond statements, this one required a color printer. It could even be described as cheeky: It's for the sale of the city's first green bond, and every reference to "green bond" or "green project" is printed in green ink.

Kidney, the city's finance director who shepherded the $11.3 million sale last year, says the green ink originally started out as a joke.

But then, he thought, why not? When the projects are fully implemented, Lawrence is projected to save 3,201 tons of carbon dioxide equivalents (CO2e) annually, which is equal to burning 3.5 million fewer pounds of coal. "I get really passionate about this stuff," Kidney says. "I was just so excited that Lawrence stepped up to be a leader in sustainability."

Green bonds are an emerging category of finance. Their purpose is to fund projects with clear, definable and measurable environmental benefits. As the Trump administration has walked back federal climate change policy — most notably, backing out of the Paris Agreement — states and localities are increasingly taking charge of their own environmental strategies. Green bonds are a natural funding tool. The vast majority of them finance water-related projects, but they also are used to finance, for instance, solar and wind power or reduced methane emissions. In Lawrence's case, they are funding a slew of energy efficiency projects identified by a state Facility Conservation Improvement Program audit. The audit determined that certain upgrades, such as energy-efficient lighting and heating and cooling systems, would reduce the carbon footprint for this city of 96,000 and save it money in the long run.

The concept of green bonds was developed a little more than a decade ago by a London-based group called the Climate Bonds Initiative. The idea was to help the world's growing cadre of environmentally conscious investors identify climate-friendly investments. These are folks who aren't only interested in a financial return on their investment. They want to know that their money has helped improve the environment. "If you're doing a bond issuance that's electric or coal generated, those investors don't want to be part of that transaction," says Tim Fisher, government affairs manager for the Council of Development Finance Agencies. "They're putting their investments into securities that have a double- or even triple-bottom line."

For the first few years, green bonds remained something that only large global institutions like the European Investment Bank and the World Bank dabbled in. It wasn't until 2013 that the first green bond issuance made its way to the U.S. municipal market when Massachusetts sold $100 million in bonds to finance energy efficiency projects. The following years saw other large issuers like California and New York take part. To date, those three states — Massachusetts, California and New York — are by far the most frequent issuers, accounting for $2 out of every $3 of green bonds issued in the past five years. More recently, a few municipalities have begun to experiment with them. But even as muni market issuance of green bonds doubled last year to $11 billion and is predicted to

almost double again this year, green bonds remain largely outside of the mainstream.

So it's saying something when a place the size of Lawrence decides to jump in. The city may very well be a bellwether of the next big leap for green bonds. That would be good news for issuers since the bonds have the potential to attract a fresh set of investors at a time when tax reform has created fewer incentives for banks and insurance companies to buy municipal bonds. Some even think that green bonds will someday be cheaper for states and localities to issue than general obligation debt. But before any of that happens, there are underlying challenges with green bonds' authenticity that have to be resolved first.

Since they debuted a decade ago, green bonds have been issued under a variety of names — environmental impact bonds and climate bonds being among the most prevalent. Whatever their name, one of the biggest threats to the long-term viability of these bonds is a matter of meaning. The definition of what's "green" seems to alter slightly with each issuer.

In recent years, some groups have taken a stab at narrowing down the variables in what makes a bond green. Moody's Investors Service has come up with a green bond assessment tool, which looks at the likelihood that the bond money will go toward environmental improvements. S&P Global Ratings has also come out with commentary. But neither provides a rating or measurement of how environmentally positive a bond might be. Elsewhere, the Climate Bonds Initiative has released a set of green bond principles for issuers while state and local governments are increasingly seeking third-party certification for their green bonds.

Compounding matters is the reality that the investment community doesn't agree on what's green and what isn't. Everything is optional. Julie Egan, director of municipal research at Community Capital Management, a major green bond investor, says her standard for "green" is that it has to be an innovative project. But that doesn't always apply when she's shopping for some of her clients who might not feel the same way. When she looks at a water and sewer system's green bond sale, she often sees something that looks like "the exact same thing they've been doing for years. Is it green? Technically, for some people, it is: They're providing clean water," she says. "But there's no new technology. It just is not something that would create a great deal of excitement at our firm."

Clearly, what some might see as environmentally forward-thinking in one place is just run-of-the-mill in another. It's led to accusations of so-called greenwashing, a term originally coined in the 1980s and meant for corporations that present themselves as caring environmental stewards, even as they are engaging in environmentally unsustainable practices. Some governments are now being accused of slapping on a label to entice investors while doing nothing else to ensure the sustainability of a project. Case in point: In early 2015, the Climate Bonds Initiative's CEO called out the Massachusetts State College Building Authority for its "pathetic" green bond sale that included funding a garage for 725 cars. Until these inconsistencies are resolved, the future of green bonds will remain in doubt.

For water utilities, green bonds have seemed like a natural fit. The reasons are fairly obvious. These authorities spend a lot of money on cleaning water — a slam dunk of an environmental benefit if ever there was one. Water and sewer authorities have many ways in which they go about defining, packaging and communicating about their green bonds. That is, many green bond investors want additional reports on the environmental impact of the projects they're financing. For issuers, that's an additional process.

The way in which DC Water handled its green bond is an early model. DC Water, which serves the greater Washington, D.C., region, was the first water authority to issue green bonds, not just in the U.S. but globally. In July 2014, it sold $350 million in environmental impact bonds to finance a phase

of its Clean Rivers Project. In part because the concept was so new — it was only the third green bond issuance in the U.S. — DC Water looked to Europe for best practices. Following the green bond principles outlined by the Climate Bonds Initiative, it opted to get a third-party verification and used that to both market the sale and offer a glimpse into the sort of annual impact reporting investors could expect on the bonds' proceeds. "Quite frankly, for DC Water, we wanted to set a high bar because we wanted to distinguish ourselves from other issuers," says Mark Kim, the authority's former chief financial officer and now the chief operating officer of the Municipal Securities Rulemaking Board.

The approach worked. In fact, DC Water upsized its issue by $50 million on the day of the sale thanks to the high demand from investors. Since then, the authority has issued more than a half-billion dollars in green bonds. It releases annual green bond reports that detail where all that money is being spent and gives updates on environmental outcomes. Investors who bought a DC Water green bond in 2014, for example, know that their money helped finance the first phase of the DC Clean Rivers Project, which has now helped significantly reduce nitrogen and phosphorus levels in the Anacostia and Potomac rivers.

That level of reporting isn't for everyone. And that's another challenge for the green bond movement. The additional reporting can be expensive, though it doesn't necessarily have to be. In some cases, as in Lawrence, the impact reporting is already part of the project: Lawrence has a sustainability coordinator whose job includes reporting on the city's energy savings and carbon emissions.

There are other strategies. In 2016, when the Massachusetts Water Resources Authority issued $682 million in green bonds, the first of what has been a handful of green bond sales for the authority, it took steps to avoid the extra cost of ongoing environmental impact reporting. All the bonds have been refinancings for projects completed under the federal Clean Water Act and Safe Drinking Water Act. "We thought it would be just as easy to issue refundings as green bonds because investors already know what that money was spent on," says CFO Tom Durkin. "We have limited resources and try to be frugal here. To have to produce a glossy five- or six-page report seemed like one more burden we didn't want to put on our Treasury Department."

Cleveland, on the other hand, made no claims about impact reporting in its 2016 green bond sale. It offered up $32 million in green bonds for stormwater projects and sewer upgrades and repair, telling investors in its offering statement that the city assumes no obligation to ensure the projects comply "with any legal or other standards or principles that relate to Green Projects." Instead, it committed to simply reporting on the use of proceeds until the bond money was spent. Investors bought them anyway.

Many issuers remain unconvinced of the advantage of green bonds. In part that's because there has yet to be a proven pricing benefit. The bonds don't win better rates from investors to justify the expense of the additional reporting, but Lawrence's Kidney and others make the case that selling green bonds opens up governments to new institutional investors. These are people who sit on the environmental or social investing side of a firm — nowhere near the municipal investor desk. For others, like the Eastern Municipal Water District in Southern California, that's just not enough of a selling point. "[When] we start to see a pricing bump," says Eastern's Deputy General Manager Debby Cherney, "then we'll certainly take a much more serious look at coming into the market."

Without agreed-upon standards about what a green bond is and what the reporting requirements should be, some say it's only a matter of time before an issuer falls out of favor by either using proceeds for a project that isn't green, or by not delivering on the environmental impact reporting that's expected. Until that happens — and some believe it's inevitable — governments are likely to

keep pushing the margins. “Not all green bond issuers are alike and I’d say some have not adhered to best practices,” says Kim, the former DC Water CFO. “Some have taken liberties with their designation.” But he thinks enforcement has to come from investors. “They need to do their due diligence and hold municipal bonds accountable for what they’re selling,” he says. “And if they don’t like what they see, don’t buy it.”

Maybe. Perhaps this new breed of environmentally conscious buyers will be different, but relying on investors to police the muni bond market hasn’t worked before. It’s more likely that until there is a real cop on the beat to instill some kind of standard, the legitimacy of the green bond market as a whole will remain in question.

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