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Green Bonds Are in High Demand, But Are They a Better Deal?

Green bonds help governments finance environmental projects. It's unclear whether they help governments' finances.

States and localities spend billions on infrastructure every year. Going forward, Christiana Figueres, the former United Nations climate chief, wants them to pay for it "whenever applicable" with green bonds — an emerging way of financing projects with clear and measurable environmental benefits.

The push by Figueres is part of a new initiative called the "green bonds pledge" to ensure that all infrastructure built from now on is climate-resilient and low carbon. In her address at a Climate Bonds Initiative event in London earlier this year, Figueres promised the governments and corporations taking the pledge that "a wealth of opportunity will be unlocked."

But opportunity for who?

While the benefits for the environment are clear, it's much less clear that governments issuing green bonds get any better treatment than those issuing other types of debt. Even the Climate Bonds Initiative has found no conclusive evidence that green bonds are cheaper for governments to issue. So far, it seems that any evidence of a rate advantage for green bond issuers can be accredited to unrelated factors.

One of those factors is supply and demand.

Green bonds are still a tiny part of the bond market, but more and more investors are being compelled to buy them to meet environmental mandates. Green bonds are often oversubscribed, meaning there are more orders placed to buy bonds than are available to sell. The average green bond sale in the U.S. is three times oversubscribed, according to research by the Climate Bonds Initiative.

Demand certainly helped DC Water when it issued the first-ever green bond by a water utility in 2014. The utility actually upsized its issue by $50 million on the day of the sale thanks to the high demand from investors, says DC Water's former chief financial officer, Mark Kim.

Another factor driving better rates for some green bonds is the reputation and transparency of the government issuer.

DC Water, for instance, has a good reputation in the municipal market in part because it releases annual green bond reports that detail where all that money is being spent and gives updates on environmental outcomes. But that's not the case with every green bond issuance and, therefore, may affect what rate issuers get.

Overall, there is evidence that good transparency and reporting standards — not just for green bonds — can help government issuers get a better rate. The state of Massachusetts was one of the first major governments to embrace this idea when it began allowing investors to buy bonds directly from the state, rather than going through a broker, and launched an investor relations page where bond buyers could find all the state's financial and interim disclosures.

Colin MacNaught, who helped spearhead that effort and now runs a startup called BondLink that helps governments create investor relations sites, says any pricing bumps in the green bond market work the same way. "That granular detail is super important," he says. "Managers want to report back to their investors on the environmental impact their fund is having."

MacNaught adds that governments already do a lot of analysis on a project's expected impact before it sells the bonds. So committing to consistent impact reporting, he says, shouldn't be too much more of a stretch. "If an issuer can do that, you'll see an impact on pricing."

For these reasons, Dan Kaplan, who manages the $3.9 billion portfolio for the wastewater treatment division in King County, Wash., says green bonds are "much ado about nothing." Municipal bond sales in general are often oversubscribed, he says, so the notion that green bonds generate "extra" demand is misleading.

Kaplan agrees with MacNaught that better reporting, as well as a good credit rating, are what bring down the cost of issuance — not some "external label" applied to projects that governments would be doing anyway. "What you're seeing is not even necessarily a bump from transparency," he says, "but the benefits of being a large, well-run and well-established organization."

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