Can Booming Green Bonds Finance Sustainable Cities?

In this three-part blog series "Making Vanilla Green or Making Green Vanilla," EDF+Business Sustainable Finance Manager Jake Hiller, and Clean Energy and Sustainable Finance Intern Gabriel Malek unpack how an environmental advocacy group like EDF could best use its resources and expertise to drive impact in the fixed income market. This research is informed by interviews conducted with Eric Glass, Senior Portfolio Manager at AllianceBernstein and founding member of the Municipal Impact Investment Policy Group; Rob Fernandez, Director of ESG Research at Breckinridge Capital; and Navjeet Bal, General Counsel of Social Finance Inc. and former Commissioner of Revenue of the Commonwealth of Massachusetts.

Over the past few years, experts in socially responsible investing have become increasingly intrigued by green bonds, financial vehicles designed to kickstart environmental projects. In 2016, both EDF and the *Stanford Social Innovation Review* examined the strengths and challenges of the growing green bond market and outlined how this novel financial tool could help channel capital to sustainable development initiatives. Since the publication of these articles, the green bond market has expanded dramatically. In the US alone, the value of green bonds between 2016 and 2017 doubled to $48 billion. What began in 2008 with an experimental, World Bank-issued "green" labelled bond has since developed into a $155 billion market that is projected to expand this year.

Given this boom, a renewed examination of the relationship between environmental advocacy organizations, investors, and the fixed income space — both green and vanilla — seems appropriate. EDF has used its clout to influence private equity strategies but has yet to similarly influence the bond world. As it works to shift financial markets, EDF and similar nonprofits must understand fixed income's environmental gaps that could hinder sustainable progress. Moreover, advocacy groups must focus on fixed income as they rely on municipalities, which depend on bonds, to catalyze investment in coastal resilience. This three-part blog series attempts to highlight some of these gaps and discuss potential actions that environmental advocacy groups could take to ameliorate current problems.

Specifically, this series asks whether helping further grow the green bond market or improving environmental reporting in the standard, vanilla bond market would more effectively drive sustainable impact. Although green bonds have taken off in the last decade, they still account for only a sliver of the total fixed income space, representing approximately 1 percent of the worldwide bond market and .06 percent of the US bond market. Could green bonds, despite being only a tiny portion of fixed income, generate substantive change? And ultimately, what should environmental nonprofits do — make green vanilla or vanilla green?

Growing the Green Bond Market

Advocacy groups could benefit from capitalizing on the current buzz surrounding the green bond market.

"We participate in a number of green bonds because they receive a lot of attention and support," said Rob Fernandez, Director of ESG Research at Breckinridge Capital. "They enhance an issuer's reputation by highlighting the issuer's sustainability. Issuing a green bond also expands an issuer's investor base; it can bring in normal fixed income investors as well as ESG investors."

Additionally, green bonds have more rigorous environmental disclosure requirements than vanilla bonds.

"We like green bonds because of the transparent use of proceeds," Fernandez explained. "Issuers can comply with the green bond principles and release impact reports annually. These reports give us information to share with our clients to show them how their money is going towards worthwhile projects."

Still, some investors fear that these marketing advantages can result in a green-washing effect, allowing unsustainable bonds to pass as environmentally friendly.

"The problem I have is that there's no narrative behind the green bond certification," noted Eric Glass, Senior Portfolio Manager at AllianceBernstein and founding member of the Municipal Impact Investment Policy Group. "Why was bond x certified? The system is too much of a black box. I want to have the raw data in my hands and decide for myself whether or not I think a certain project is environmentally beneficial. Some investors are fine with the third party assessments and don't care who analyzes a bond so long as it's labelled green. I care. I think we need more open source data."

Others, however, are less convinced that green-washing is a problem.

"I would push back on that criticism," countered Navjeet Bal, General Counsel of Social Finance Inc. and former Commissioner of Revenue of the Commonwealth of Massachusetts. "For decades, the government has always done this stuff, whether it's supplying clean drinking water or open space preservation."

In Bal's opinion, just because green bond-backed projects are not new, does not mean they do not benefit the environment.

Whether or not green bonds offer novel advantages remains unclear. At this point, labelling bonds "green" may be more of a branding strategy than a tool to bridge the financing gap for sustainable infrastructure projects. Still, just because green bonds have not yet brought new types of environmental projects to market does not mean they lack the potential to do so. Advocacy organizations could perhaps harness green bond enthusiasm to effect more substantive, innovative change.

Lowering the Cost of Capital

Regardless of their stance on green-washing, investors across the industry agree that green bonds have yet to lower the cost of capital for bond issuers. Until labelling a bond "green" actually reduces interest rates for debt issuers, green bonds will struggle to help bring new environmental projects to market.

"Right now, it's a buyers' market, so there is no pricing benefit for issuers who produce green bonds," Glass noted.

Although the green bond market has boomed in recent years, demand might still be too limited to lower the cost of capital. Glass believes that once environmental data becomes more robust, investor demand will reach an impactful threshold.

"Oversubscription is what allows bankers to lower the yield. But if an issuer doesn't provide enough relevant information, there won't be any sort of oversubscription. There needs to be greater transparency before enough investors are interested in green bonds to lower the cost of capital."

An organization like EDF could work with bond issuers to improve environmental reporting. This strategy could increase the number of investors interested in green bonds, ultimately allowing bond issuers to release debt at a lower cost.

Others experts, however, feel that the problem surrounding cost of capital lies in US financial markets more broadly.

"The reality is that interest rates have been so low that it's hard to really detect if there has been a change in the cost of capital," Bal remarked.

Perhaps, then, green bonds can impact cost of capital more thoroughly than experts currently believe. Green bonds' effects will become clearer when interest rates rise.

Takeaways

Whether or not green bonds can transform the fixed income market to compel investors to drive capital towards sustainable development remains unclear. Green bonds have struggled to diminish the cost of capital for issuers, leading some experts to believe these relatively new bonds contribute to greenwashing.

Still, despite these potential downsides, green bonds have drawn unprecedented interest in climate finance. Environmental advocacy groups may want to grow the green bond market as a stepping stone towards larger ambitions. If intrigue swells, nonprofits may be able to convince investors to reimagine more traditional aspects of the fixed income market using an environmental lens. In the next installment of this series, we will discuss potential long-term next steps EDF and its counterparts could take to influence the standard, vanilla bond space.

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