Bond Case Briefs

Municipal Finance Law Since 1971

Green is Good – Green Bonds Continue Growth.

Green bonds are hot. According to the Climate Bonds Initiative, global green bond issuances in 2019 exceeded $150 billion USD through August and forecasts have increased to $250 billion USD for the year. If these forecasts are met – or the market even comes close – 2019 will easily mark the largest annual green bond issuance to date.

The green bond market matches investors looking to support projects with specific environmental or "green" attributes with borrowers who want to finance those projects. This unique ability to connect market participants during a period of increasing concern for climate-related risks has driven this market's impressive growth over the past decade. In fact, the green bond market continues to attract increased interest and has become one of the most visible examples of the rapid growth and acceptance of environmental, social and governance, or ESG, investing. As the global green bond market continues to grow and develop rapidly, a brief overview of green bond fundamentals is timely for those wanting to learn more about this dynamic market.

A brief history

Emerging in 2007, the green bond market developed on a voluntary and self-regulatory basis. Prior to the advent of green bonds, global bond markets had financed, and continue to finance, substantial investments in projects with environmental benefits. However, the landscape shifted in 2007 when the European Investment Bank issued a €600 million "Climate Awareness Bond" and in 2008 when World Bank issued $300 million USD Green Bonds. The groundbreaking aspect of those transactions was providing investors a product that targets capital to projects with specific attributes. In these cases, the projects had green attributes. And while innovative financing techniques continue to emerge within the green bond market, the overall story is less about new financing vehicles than it is a movement to facilitate purpose-driven investment strategies.

Growing concern for climate-related issues, particularly in Europe, made green bonds an attractive investment opportunity and the market steadily grew and began to receive mainstream acceptance in 2013 and 2014. In an attempt to provide guidance to market participants, the International Capital Markets Association released the first version of its Green Bond Principles in 2014. The Green Bond Principles is one of the most widely referenced set of green bond guidelines, and it sets forth best practices for green bond issues in an effort to increase transparency and legitimacy for the self-regulated market. Another notable institution in the green bond market, the Climate Bonds Initiative, has created a labelling program for green bonds that integrates the Green Bond Principles and conforms to the requirements of the Paris Agreement.

Green bonds have now expanded across global financial markets. From 2007 to 2018, nearly $580 billion of green bonds were issued globally, and growth is accelerating in 2019. And although European issuers continue to lead the way based on volume, green bonds are rapidly growing in the Americas and Asia.

What is a green bond?

Green bonds are not currently subject to a universal standard or definition. The fundamental characteristic of a green bond is that the bond proceeds are used for projects that possess green attributes. Green bonds raise funds for new and existing projects. In fact, many green bonds raise funds in advance of knowing the specific projects to which the capital will be allocated. In cases such as these, the issuer's framework and criteria for allocating funds is critical. Although some issuers may be reluctant to place overly restrictive parameters around their allocation decisions, more general or ambiguous selection criteria increases the potential for criticism. Thus the "Use of Proceeds" section of a prospectus and restrictions on use in any transaction documents are central to evaluating any green bond.

Issuers decide whether to label their bonds as green. While not required, many issuers seek the additional legitimacy of independent verification or certification and engage third-parties to review the green attributes of the bonds and the anticipated impact of the investment. Other than the targeted use of proceeds and any ancillary services related to verifying and certifying the use of proceeds, green bonds are quite similar to other bonds.

Green bonds finance a broad range of assets with a majority going to energy, building, transportation and water-related projects. Issuers of green bonds include sovereigns, local governments, government-backed entities and financial and corporate entities.

Measuring impact

One of the most scrutinized areas of the green bond market is assessing the environmental impact of green bond issuances. Green bond issuers must determine whether to (i) hire a third party to review the initial bond offering, (ii) undertake any ongoing reporting obligations and (iii) engage third-parties to verify any ongoing reporting obligations. Although generally relatively modest, agreeing to such actions does add to offering expenses and employee time commitments. Offsetting these costs is the fact that verification and continued reporting provide greater transparency and assure investors that funds are deployed as expected and do, in fact, make a positive environmental impact. Verification and continued reporting also reduce the risk of "greenwashing," the practice of using funds from green bonds for non-green purposes. These additional actions also help to promote the integrity of the green bond market and may very well become more common, or even required in certain jurisdictions, as the green bond market continues to mature.

Why issue a green bond?

In addition to the environmental benefits derived from the projects financed, green bonds carry important tangible and intangible benefits for both issuers and investors. For issuers, green bonds:

- diversify an investor base – green bonds are sought by a growing class of investors, several of which have environmental or other investment mandates
- increased demand – green bonds tend to have wider margins of oversubscription than comparable conventional bond offerings
- investor communication – green bonds demonstrate the issuer's commitment to values that investors, not to mention citizens, customers, shareholders and other stakeholders, find important
- price – recent evidence suggests that green bonds may be developing a small pricing advantage, or "greenium," over comparable non-green bonds.

For investors, green bonds:

- meet investment objectives – a growing number of investors have aspirational or mandatory green investment objectives

- financial performance – green bonds offer risk-adjusted returns generally consistent with more conventional bonds
- potential liquidity – green bonds have demonstrated stronger secondary market performance than conventional bonds.

A Look Ahead

As the green bond market continues to mature and attract increasing amounts of capital, regulators in several jurisdictions have moved to shape and align definitions and qualifications to promote legitimacy and consistency. For example, the European Union's Technical Expert Group on Sustainable Finance issued a report in July 2019 including recommendations to create standards and labels for green financial products. The resulting program, if adopted, would create a voluntary, non-legislative EU Green Bond Standard seeking to standardize comparability and credibility of the green bond market.

Not coincidentally, the green bond market's rapid growth is occurring as nations and corporations and seek to reduce carbon emissions. As global pressures for decarbonization continue to increase, we expect that the green bond market will continue to expand and play a critical role in the growth of green finance more generally. As investors increasingly seek the dual promise of positive financial and social returns, green bonds offer a promising method to cater to that appetite.

September 12, 2019

Eversheds Sutherland (US) LLP