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Green Muni Bonds Are Blooming Slowly.

What does the market for green muni bonds look like, and where is it going?

Investors today can expect to see a plethora of gardening-related puns when reading about the blossoming green-bond market. Green bonds, fixed-income instruments whose use of proceeds are specifically linked to the undertaking of environmentally sustainable projects, have surged in size over the previous decade. We dug into this topic in our recent white paper, including assessing the growth of the green-bond market itself, how asset managers both in the United States and in Europe are seeking to take advantage of this new market, and whether these bonds belong in your portfolio.

While dozens of green-bond strategies have emerged over the last several years, significantly fewer have arisen with a specific focus on the municipal market. This may be surprising for some given that the U.S. muni market, where many issuers have been offering debt that supports environmentally responsible infrastructure projects for decades, appears a natural fit for green bonds. Why are there not more green-bond muni strategies for investors to consider? Should tax-free investors keep their eyes peeled for such an option? Here, we dig further into the green-muni-bond market to learn more.

Green Munis: Growing, but Still a Tiny Part of a Niche Market
As with many areas of the world, the green-bond market within the U.S. has grown quite rapidly over the last few years. According to the Climate Bond Initiative, a nonprofit that certifies green bonds, total U.S. green-bond issuance grew from $12.8 billion over the 2015 calendar year to $61.5 billion over 2020.[1] The majority of this issuance stems from taxable issuers, including from major securitized players like Fannie Mae and from corporations like Apple and Coca-Cola. Yet muni bonds are no small part of this market: of the $61.5 billion of total issuance over 2020, 25% ($15 billion) stemmed from muni issuers.[2] This too represents a substantial increase over the same period; in a 2017 analysis, Nuveen Asset Management cited Bloomberg data showing that green muni issuance was just over $4 billion over calendar 2015.[3]

This growth is impressive but represents merely a drop in the bucket of total U.S. muni issuance. According to the Securities Industry and Financial Markets Association, the U.S. muni market reached just shy of $4 trillion outstanding at the end of 2020, with $485 billion alone issued over 2020[4]; the $15 billion in green muni debt cited earlier represents just 3% of that total issuance. Most of this debt is held directly by individual investors or through mutual fund strategies. Additionally, the market remains fragmented and less liquid than the U.S. corporate bond market as there are about 1 million outstanding muni securities, and only between 30,000 and 40,000 of them trade on an average day.

Certifying Green Munis Remains Tricky
Investors should also note that there’s currently substantial uncertainty in the market over how to determine which muni bonds are truly “green.” “Greenwashing,” wherein companies advertise stronger environmental, social, and governance standards than they are truly practicing, is a serious concern for sustainability-minded investors across asset classes. Within munis, part of the problem is that most muni issuers have arguably been working alongside green principles long before green

bonds emerged as an asset class. Organizations like CBI, which offers its own certification service for green bonds, and the International Capital Markets Association, which since 2014 has published a set of voluntary reporting principles for green bonds, seek to minimize the risk of greenwashing by providing issuers a framework through which to prove their proceeds are going to environmental projects. A plethora of second-party opinion organizations, including Kestrel Verifiers and Morningstar-owned Sustainalytics, have emerged over the same period offering to substantiate which issuers are offering truly “green debt.” Many muni issuers, whether or not they are intentionally adhering to these frameworks, might be issuing debt that qualifies for consideration but are just not seeking out those green designations. A substantial part of the muni market over the past several decades has been debt issued by states and local authorities to finance construction of capital infrastructure projects, including improvements to water mains, new water and sewer treatment facilities, renewed roads and bridges, and energy-efficient electric utilities. Many of these projects would likely fulfill the use-of-proceeds requirement of a green mandate but just aren’t labeled as such.

Even so, caution is warranted in determining which muni bonds are truly green. In a 2019 opinion piece in the *Bond Buyer*, Dana Villanova and Monica Reid of Kestrel Verifiers noted that while the ICMA and CBI encourage issuers to undergo independent external reviews, muni issuers are still able to “self-label” their debt as being green, and there is no mechanism for removing the green label from a muni bond that does not meet its original output goals as long as the funds are used for their original purpose.[5] With these factors under consideration, both CBI certification and additional verification from SPOs have become quite popular in the taxable green-bond market as investors seek ways to determine which bonds are truly following ICMA and other green-bond principles.

Within munis, however, this type of work remains somewhat stunted in comparison. The managers of Wells Fargo Municipal Sustainability (WMSAX), a strategy focused on investing in muni bonds with strong ESG characteristics, noted that CBI certifications and SPO verifications are rarer in the muni market given the budgetary restraints of the issuers themselves. U.S. municipalities, the majority of which are smaller agencies, often operate with limited budgets, and staff and may struggle to justify the added expenses of tracking bond proceeds and preparing annual disclosures to meet green certification requirements. This problem is compounded by the fact that green muni bonds themselves don’t appear to trade with the same price premium (often dubbed a “greenium”) exhibited by taxable issuance. To varying degrees of intensity, many market observers have noted that when issuers issue both a green and a nongreen bond with otherwise identical characteristics, the green bond will trade with a higher price (and thus lower yield) than its nongreen equivalent. Generally, this would suggest that investors are willing to be compensated less in their quest for investing sustainably, and issuers can expect to pay less over time for a green bond than a nongreen bond. Wells Fargo, for their part, stated that it did not see evidence for a greenium within the muni market. Furthermore, in a 2020 study entitled “Where’s the Greenium?”, David Larcker and Edward Watts, Stanford and Yale academics writing for the *Journal of Accounting and Economic*s, concluded that investors appeared unwilling to pay more for green munis than their traditional equivalents and suggested that there was no greenium within the muni market.[6] While muni issuers may have an incentive to self-label their bonds as being green in some circumstances, the financial incentive to undergo a formal certification and verification process through a third-party appears less clear.

All things considered, investors may therefore want to take the headline growth of the green muni market with a grain of salt. Even with third-party certification and SPO verification, there is room for additional due diligence to ascertain which green bonds are truly meeting sustainability objectives across the broad fixed-income market. Given the additional certification challenges within munis, investors should be doubly cautious while considering this asset class.

What Are Your Investing Options?
Perhaps in part because of these challenges, the investing universe for green muni strategies remains limited in 2021. As of July 2021, there are only two strategies available to U.S. investors that focus exclusively on green muni bonds: Franklin Municipal Green Bond (FGBKX), incepted in October 2019, and Green California Tax-Free Income (CFNTX), incepted in December 1985 but rebranded as a green-bond fund in 2019. Franklin Municipal Green Bond defines green bonds as those funding projects linked to environmental sustainability. The fund's prospectus, however, acknowledges that while the managers may consider external reports (such as those provided by CBI certification or by an SPO) while determining which bonds are green, ultimately they can choose to invest in any issuers they determine as meeting their stated requirements of a green bond. The strategy has a limited record given its relative youth and remains small: The fund's AUM was just $8 million as of May 2021, and it held only 55 individual securities as of that date. Green California Tax-Free Income is larger and has a longer track record but has applied ESG screens to its investment process only since 2019; while the strategy seeks to be a "green-bond fund" according to its prospectus, it can invest in any issues it judges as meeting its proprietary ESG screens.

These two strategies, both actively managed, do not have any passive competitors. The market for green muni indexes remains quite slim, with the S&P U.S. Municipal Green Bond Index being the only one extant as of July 2021. This index tracks muni bonds which are judged to be green via a certification from CBI. VanEck mentioned this index in the context of its launch of VanEck Vectors Green Bond ETF (GRNB), which tracks the S&P U.S. Select Green Bond Index. The managers there determined that while the universe of U.S.-domiciled, CBI-certified taxable green bonds (which the latter index tracks) was broad and developed enough to support a passive product, the muni market remained too small and concentrated to support a muni-focused product. The amount of issuers in the green muni bond index versus the broader S&P Municipal Bond Index underscores that fact: Whereas the S&P Municipal Bond Index tracked more than 200,000 constituents for a total market cap of $2.7 billion as of June 2021, the S&P U.S. Municipal Green Bond Index tracked just over 2,850 constituents for a market cap of $53 million.[7]

The path forward for the green muni bond investor is uncertain, with both the current strategy options and the incentives for green muni bonds limited. Yet there is optimism that the market for both green muni bonds and for the strategies that invest in them will grow substantially in the years to come. Lauren Kashmanian of Parametric Portfolio Associates, in an interview with Bloomberg News, anticipated that total green muni debt issuance could balloon to $30 billion-35 billion in the wake of additional federal stimulus for U.S. infrastructure.[8] Should the market continue to expand, however, green muni investors should consider their options with a discerning eye and seek to invest with managers with proven teams, sensible processes, and low fees.

[1] Climate Bond Initiative. 2021. "Sustainable Debt: Global State of the Market 2020." https://www.climatebonds.net/resources/reports/sustainable-debt-global-state-market-2020

[2] Ibid.

[3] Liberatore, S., & Levy, J. 2017. "Green Muni Bonds: Responsible Investing in a Centuries-Old Asset Class." TIAA. https://www.tiaa.org/public/pdf/C29869_TGAM_whitepaper_muni_bonds.pdf

[4] Securities Industry and Financial Markets Association. "U.S. Municipal Bonds: Issuance, Trading Volume, Outstanding, Holders." https://www.sifma.org/resources/research/us-municipal-bon-s-statistics/

[5] Villanova, D., & Reid, M. 2019. "What's in a Municipal Green Bond?", The Bond Buyer. https://www.bondbuyer.com/opinion/whats-in-a-municipal-green-bond

[6] Larcker, D., & Watts, E. 2019. "Where's the Greenium?", J. Accounting and Econ., Vol. 69, No. 2–3, P. 101312. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3333847

[7] S&P Dow Jones Indices.

[8] Moran, D. 2021. "Biden Spending Plan Seen Jolting Muni Green-Bond Sales to Record," Bloomberg News. https://www.bloomberg.com/news/articles/2021-04-20/biden-spending-plan-seen-jolting-muni-green-bond-sales-to-record

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by Gabriel Denis

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