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Investors still have trouble understanding 'green bonds,' but variety grows

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A new analysis examining U.S. "green bonds" finds that investors have a growing appetite for environmentally focused financial instruments. But the market is hindered by a lack of understanding about the variety of bonds available and how they work, as well as investor concerns about liquidity, credit quality and bond size.

Those findings were presented yesterday by two nonprofits, the Clean Energy Group and Croatan Institute, following a 12-month investigation of investors' attitudes and behaviors toward the fixed-income securities that can be used to finance clean energy generation, transmission and distribution, as well as energy efficiency programs and other environmental projects.

Yet, even as opportunities around green bonds expand, "what this market has lacked is a strong understanding of investor demand for these clean energy and green bonds in U.S. markets," the report states. "Without a clear sense of this demand, this market will not expand at the scale needed to finance badly needed climate and energy solutions."

The 40-page report seeks to provide a blueprint for investors, bond issuers and underwriters to help realize the full potential of green bonds, according to its authors.

Among its recommendations, the paper calls for a deeper probing of green bond markets "to develop a more complete picture of the specific, disaggregated demand characteristics of active investors." For example, "considerably more research could be done with public funds, corporate treasurers, college endowments, and larger mutual funds and asset managers," the authors wrote.

The analysis also calls for "new collaborative frameworks for bond buyers to convey their demand expectations to issuers and educate wider groups of institutional investors, bond buyers, underwriters, and investment consultants about the opportunities associated with clean energy bond financing."

Among the more likely buyers, it points to investors seeking to divest from fossil fuel firms and companies that rely heavily on fossil fuels because they worry that regulations may make them stranded assets.

A 2-decade history

"For those who want to take the money away from fossil-fuel companies, they should also consider ways to take their market away by investing in clean energy bonds," Lew Milford, president of the Vermont-based Clean Energy Group, said in a statement.

Green bonds, while only recently labeled by as such, have existed since the 1990s, when bonds were issued often by municipalities to finance small renewable energy projects or other energy programs. In the 2000s, international development banks greatly expanded and redefined the market with offerings such as "climate awareness bonds" in Europe and AAA-rated "green bonds" issued by the World Bank to a group of Scandinavian investors.

Since then, the market has grown to include municipal bonds and project bonds to meet specific environmental goals, even if they were not called "green bonds." For example, San Francisco in 2001 issued a $100 million revenue bond to build solar and wind power capacity throughout the city.

In the late 2000s, Congress created the Clean Renewable Energy Bond and Qualified Energy Conservation Bond programs to provide no- and low-interest debt financing to rural electric cooperatives, Indian tribes, municipalities and other nonprofits to encourage investment in clean energy, energy efficiency and conservation.

Then last year, the International Capital Market Association, working with leading underwriters, developed a set of "Green Bond Principles," or voluntary guidelines that "recommend transparency and disclosure and promote integrity in the development of the Green Bond market."

Widening spectrum of uses

As part of that process, ICMA broadly defined green bonds as "enabling capital-raising and investment for new and existing projects with environmental benefits." Such projects could include renewable energy development and energy efficiency projects as well as building upgrades and retrofits, waste management projects, alternative transportation programs, investments in sustainable land use and biodiversity conservation, and spending on clean water infrastructure.

The principles won endorsement from 25 global investment banks, among them Wall Street giants Bank of America Merrill Lynch, Citi Group, JPMorgan Chase, Goldman Sachs and Morgan Stanley.

Investment banks also in 2013 began issuing corporate green bonds, spearheaded by Bank of America's $500 million green bond offering for investments in wind, solar and geothermal plants as well as energy efficiency projects. Today the corporate green bond market, fueled by a series of benchmark-sized offerings by banks and private companies, is valued at $6 billion, the report states.

At the same time, a number of benchmarking firms -- including Barclays/MCSI and S&P Dow Jones Indices -- have created indexes that allow investors to better gauge how certain green bonds are performing.

However, the CEG/Croatan analysis found, "the relatively small and rapidly changing sample size of green bonds makes it hard to draw much of any conclusion about green bond performance attributes."

Rob Sanders, CEG's senior finance director and a co-principal investigator on the analysis, stressed that many of the indexed green bonds are issued by major multinational banks, leaving them outside the reach of everyday investors. At the same time, many of the most attractive green bonds are too small to be monitored by those indexes, essentially leaving them hidden from view.

"There are many investors out there who want to do the right thing, but if the costs are too high for them to play, you wind up discouraging the very people who you want to be the key players in the market," he said.

But, Milford added, "the [green bond] space is now getting more mature," and more options are becoming available to investors of all stripes -- including foundations, universities, pension funds and smaller institutional investors -- seeking to put their money behind environmentally sustainable projects.

"Clean energy bonds or green bonds could be the magic piece in the middle," he added, "and we believe it's a good place for these kinds of smart investors to begin looking at strongly."