In The Municipal Market, Green is the New Black

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U.S. investors are becoming more socially and environmentally conscious and are open to investment options that reflect their "green" preferences.

This trend toward sustainability, commonly demonstrated through reusable bags, hybrid cars, and renewable energy sources, has also gained popularity in the municipal bond market through the issuance of Green Bonds.

Municipal Green Bonds, issued by state and local governments to fund environmentally beneficial capital projects, are not currently a large percentage of total municipal bond issuance, but have recently gained significant traction. Since the Commonwealth of Massachusetts' inaugural Green Bond issuance in 2013, municipal Green Bond issuance has increased nearly threefold over a rolling five year period, jumping 40 percent YOY to reach a record $14 billion in 2020.[1] While Green Bond issuance saw strong year-over-year percentage growth in 2020, $14 billion remains a small, although growing, part of the new issue municipal market (total issuance was $470 billion in 2020).[1] Green Bond issuance continues to increase as a percentage of total issuance, accounting for 3 percent for the year as of December 2020.

Investors interested in socially responsible investments and earning tax exempt income may want to consider whether Green Bonds have a place in their portfolios. Provided that the bonds meet the investor's current investment objectives and that the investor understands the associated risks, Green Bonds may present a unique investment opportunity.

This paper seeks to provide a brief primer on Green Bonds in the municipal market, how and why they are issued, and some of the benefits and risks to consider before investing.

[1] Bloomberg Finance LLP, FCM; Mar. 25, 2021

The municipal bond market

The $3.9 trillion U.S. municipal bond market[2] plays a critical role in building and maintaining our nation's infrastructure. Municipal bonds (or "munis") are issued by government entities to finance capital projects, including public transportation systems, energy systems, clean water treatment facilities, hospitals, and schools.

Generally, the interest earned on tax-exempt municipal bonds is tax-exempt federally and within the state of issuance, making municipal bonds an attractive investment opportunity for individual investors who have a significant tax liability. Individuals, either directly as individual retail investors or through mutual funds, hold approximately 69 percent of the muni bond market.[3]

Arguably, the municipal bond market has long provided investors with the chance to invest in projects or entities that drive positive social impact through investment in their communities. However, the advent of Green Bonds presents municipalities with an innovative opportunity to explicitly market their bonds as socially and environmentally conscious investments.

In 2013, the Commonwealth of Massachusetts became the first municipality in the United States to issue a Green Bond. Massachusetts' $100 million General Obligation (GO) Green Bond series funded projects focused on clean water, energy efficiency, and habitat preservation. The Green Bonds share the same credit rating and profile as traditional Massachusetts GO bonds. However, the Green Bonds were used to finance distinct environmentally friendly projects.

What are Green Bonds?

Green Bonds are traditional municipal bonds, except that the bonds' proceeds are:

- Issued specifically to fund environmentally beneficial projects such as renewable energy, green infrastructure, clean water, waste management, and eco-friendly transportation;
- Identified or defined as green (usually in the Official Statement); and
- Monitored and reported on to ensure proper green use of the proceeds.

Other than the use of the proceeds, Green Bonds share the same basic attributes (i.e., federal tax exemption, source of payment and security, rating, and price) as the non-Green version of the same credit. For example,

- A Green General Obligation Bond is backed by the same full faith and credit as a non-Green General Obligation Bond; and
- A Green Revenue Bond is backed by the same revenue source as the non-Green version of that credit.

[2] "Federal Reserve Flow of Funds Report, Q4 2020.
[3] "Holders of U.S. Municipal Securities," SIFMA and the Federal Reserve System. As of Q4 2020.

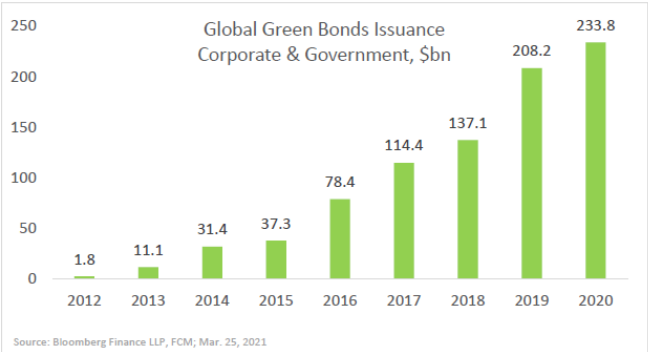
What are the benefits of Green Bonds?

For Municipalities: Many issuers hope that Green Bonds will broaden the appeal of their municipal bonds and attract a new class of environmentally conscious investors, particularly individuals. Investment in green transportation, water, power, and buildings can address a community's infrastructure need with a sustainable solution, fostering a positive environmental and social outcome.

For Individual Investors: Tax-exempt municipal Green Bonds present an opportunity to earn tax-exempt income in conjunction with an environmentally focused investment. In addition, many Green Bond issuers have provided ongoing information regarding the underlying green projects to confirm the green use of bond proceeds. This additional reporting (often annual) affords investors greater insight and transparency into how their investment is utilized.

Green Is Growing

Annual Green Bond Issuance



Shades of green: What counts as green?

One of the biggest questions regarding Green Bonds is what exactly makes an issuance green and who decides if it is green enough? To date, the principles used to define a municipal bond as green vary with each issuer.

According to the Climate Bonds Initiative (CBI), the definition of green bonds may differ widely between issuers and projects. To date, bonds are considered green if the assets and projects "deliver a low carbon economy and give GHG emissions screening criteria consistent with the 2-degree global warming target set by the COP 21 Paris Agreement."[5] However, this definition is continuously evolving with changes in technology and climate science. An important step in the development of the market was a set of Green Bond Principles (GBP) agreed to by a consortium of banks that furnished standards against which investors may assess green credentials of labeled issuance. Still, there are billions of dollars worth of labeled green bond issuance that are not aligned with CBI definitions. Yet as the market continues to grow, issuer self-labeling practices that push the limits of reasonableness may become a smaller concern.

Importantly, as with all municipal bonds, municipal Green Bonds must be issued for qualified capital projects. The difference is that the qualified capital projects for which Green Bonds are issued must also serve an environmentally friendly purpose, although this definition may vary. For example, Massachusetts Clean Water Trust, the District of Columbia Water and Sewer Authority, and the Metropolitan Transportation Authority ("MTA") each employed different methodologies to support their offerings' greenness:

The Massachusetts Clean Water Authority offers bonds consistent with the Green Bond classification, "that proceeds from the sale will be dedicated to projects that promote pollination prevention, sustainable water and wastewater management, energy efficiency, or other environmentally sustainable purposes"

San Diego County Water Authority developed its own environmentally beneficial green categories and methodologies leveraging federal and state standards to "benefit the environment and promote thoughtful stewardship of natural resources," as defined in its Green Bond Official Statements.[4]

The MTA issues its Green Bond transactions with a "Climate Bond Certified" designation by the Climate Bonds Initiative, based on "international standards for climate integrity, management of proceeds, and transparency."[5]

As green issuance increases, greater market consensus regarding what is and what is not considered green will likely evolve.

The ability to incorporate a social dynamic into investment decisions is appealing to many investors. However, when considering muni Green Bonds, it is important to carefully review the credit as you would for any other bond, paying careful attention to the backing and security for the credit. It is always recommended that investors read the Preliminary Official Statement and formulate an independent opinion as to whether the proposed project fulfills one's own scale of greenness.

Risks and considerations: Is the grass greener?

Environmental infrastructure projects funded by municipal Green Bonds are expected to have a positive impact on the towns, cities, and states that issue them. However, it is too soon to determine if there will be a consistent cost advantage to Green Bonds for issuers or investors. For many investors, the intangible environmentally friendly purpose for which the bonds are issued has its own intrinsic value. Similarly, it is unclear if Green Bonds will provide a long-term cost benefit to municipalities.

As with all municipal bonds, it is important for investors to understand the underlying credit, use of proceeds (Green or otherwise), and how it aligns with their investment objectives. Reviewing the offering document and understanding the underlying credit are important parts of any investment decision.

Outlook

The advent of Green Bonds highlights a unique opportunity for the municipal marketplace to combine innovation and social responsibility to better engage a new set of investors and enact positive change. Green Bond issuance continues to grow,[6] with transactions spanning 46 states as well as the District of Columbia and Guam. Furthering the momentum for Green Bonds, several ratings agencies have developed comprehensive methodologies for evaluating the "greenness" of Green Bond transactions. As the municipal Green Bond market matures, increased awareness and standardization could further growth potential and encourage additional municipalities and investors to go green.

[4] Massachusetts Clean Water Trust, State Revolving Fund Bonds, Series 23A (Green Bonds). https://www.munios.com/munios-notice.aspx?i=5FRTQT0zkYo1

[5] Metropolitan Transportation Authority Investor Information: Green Bonds—Climate Bond Certification. http://web.mta.info/mta/investor/new/green-bonds.htm

[6] Thomson Reuters as of April 28, 2021.

Material Referenced: "How to Issue a Green Muni Bond", Climate Bonds Initiative

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Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

Diversification does not ensure a profit or guarantee against a loss. Interest income earned from tax-exempt municipal securities generally is exempt from federal income tax, and may also be exempt from state and local income taxes if you are a resident in the state of issuance. A portion of the income you receive may be subject to federal and state income taxes, including the federal alternative minimum tax. In addition, you may be subject to tax on amounts recognized in connection with the sale of municipal bonds, including capital gains and "market discount" taxed at ordinary income rates. "Market discount" arises when a bond is purchased on the secondary market for a price that is less than its stated redemption price by more than a statutory amount. Before making any investment, you should review the official statement for the relevant offering for additional tax and other considerations.

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