Key Wealth Institute

Green Bonds Offer Opportunities – and Risks – for Socially Responsible Investors

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Since they were first issued in 2007, green bonds have become increasingly popular as a tool for socially responsible investing. Financial institutions, corporations, and government entities use green bonds to fund environmentally friendly projects such as clean transportation, renewable energy, and responsible waste management. Issuers can market these bonds as green to investors who embrace the principles of impact investing, specifically focused on the environment.

They can perform as well as, if not better than, traditional bonds. A record amount of new issuance is expected, driven by robust demand for sustainable fixed income investments, regulatory tailwinds, and a favorable credit environment.

But there are both risks and rewards. Let's take a closer look.

What Are Green Bonds?

Green bonds are fixed-income instruments, similar to traditional corporate bonds, but with an environmentally friendly use of proceeds. The primary difference is that the capital raised by green bonds is earmarked for sustainability-related projects, such as producing renewable energy for wind and solar projects or electric or hybrid vehicles.

The entity that issues these bonds publicly states how they will be used to finance these projects. That allows them to be marketed as "green" – usually after review by an external third party. Some bonds are known as "climate bonds" when they are issued specifically to finance projects that reduce carbon emissions or positively affect climate change. Some bonds are issued as "blue bonds" when they are designated for projects aimed at protecting ocean environments. Green bonds are more expansive and encompass climate and blue bonds and more.

The World Bank estimated that the market now has surged to more than $2 trillion globally, including more than $70 billion in emerging markets such as Fiji and Colombia. Bloomberg reported in April that green bond sales reached a record $163.9 billion in the first quarter of 2023, up 32% year-over-year.

How Are Green Bonds Used?

In the US, green bonds are typically issued for $10 million to $100 million to finance capital-intensive projects. Tesla Motors was one of the first major companies to raise funds through green bonds in the US, issuing a $600 million convertible green bond in 2013 to produce electric vehicles. Toyota issued an asset-backed security to finance hybrid vehicles the next year.

How Can I Be Sure I'm Investing in a 'Green' Project?

There are no universal standards for green bonds. The Green Bond Principles and Climate Bond Standards detail voluntary guidelines for compliance. Most issuers have an external party – auditors or ESG firms – prepare a pre-issuance verification report.

Once the issuers sell the bonds, they are responsible for using the proceeds in compliance with their issuance guidelines. They must produce follow-up reports distributed to investors and sometimes released publicly. The Climate Bonds Initiative, an international organization that mobilizes global capital for climate action, publishes a list of verified projects on its website.

The transparency provided by labeled green bonds has been successful in providing a strong foundation for the growing green bond market.

Why Issue Green Bonds?

The US Department of Energy (DOE) and the Climate Bonds Initiative note several advantages for companies and governments to issue green bonds. They are a good source of obtaining capital at a reduced cost. Terms of repayment are usually more flexible, enabling the issuers to support a wider range of projects. The organizations can promote their interest in improving the environment. The bonds also allow companies to diversify their investor base by connecting them with like-minded investors.

Because green bonds are debt instruments, their terms rely on the strength of the issuer's balance sheet. This means that issuers with strong credit ratings will secure the most favorable rates.

However, issuers may encounter several negatives, including added transaction costs resulting from the requirements of monitoring and reporting on the use of the proceeds. Funding projects with green bonds also typically involves a large minimum issuance.

What Are the Pros and Cons for Investors?

The appeal of socially responsible investing lures many investors to green bonds, allowing them to align their social values with their financial needs as well as to diversify their portfolios.

Additionally, some green bonds offer tax incentives, such as tax exemptions or tax credits. Green bonds may also increase investor transparency because they require ongoing regulatory reporting.

But there are risks.

Green bond market growth is reducing the liquidity risk but there may be times when liquidity issues could result in losses to bond holders needing funds, which can deter some investors. The green bond market has grown to a point where holding to maturity is not the only option. Investors can actually achieve a premium by selling into the secondary market, as there continues to be a demand for green bonds and issuance is not at regular intervals.

Experts also advise investors to beware of "greenwashing" – misleading information by an organization presenting an environmentally responsible public image. All valid green bonds should have the green label, which is a verification from the Climate Bonds Initiative.

What Kind of Green Bonds Are Available?

There are four basic types of green bonds:

1. **Bonds secured by assets**
   They are comparable to standard bonds.
2. **Bonds secured by income-producing projects**
   These can include projects funded by government tolls, excise taxes, etc.
3. **Bonds secured by a project asset**
   All assets and cash flow generated by the entity are available to investors as collateral, as with Tesla Energy, which is backed by residential solar leases.
4. **Securitized bonds**
   These are secured by an asset pool of several smaller eligible green projects from which investors can get diversification benefits by relying on the cash flows of several projects.

There are a few ways to invest in green bonds. You can buy them directly from the issuer, or you can buy them through a broker. There are also several mutual funds and exchange-traded funds (ETFs) that invest in green bonds. Still, this asset class isn't as diversified as traditional bond sectors and therefore caution, especially around concentration risk, is warranted.

For more information, please contact your advisor.

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About the Authors

Jeffrey Wolosz is a Portfolio Manager and member of the Taxable Fixed Income Team since 2019. He brings experience as a KPB Portfolio Manager and Credit Research Analyst where his focus was evaluation and surveillance of internally managed strategies and investments. Jeff's current responsibilities include portfolio management of model strategies, common trust funds and individual fixed income portfolios, as well as the Structured Cash and Money Market strategies.

Jeffrey holds a bachelor's degree in Business Administration and Master of Arts in Economics from Cleveland State University. He is also certified as an MSRB Municipal Advisor Principal.

Rajeev Sharma is Managing Director of Fixed Income Investments at Key Private Bank. In this role, Rajeev is responsible for overseeing and managing Taxable and Tax-exempt Fixed Income investments, including common trust funds, institutional model strategies and individual fixed income portfolios for both institutional and high-net-worth clients.

Rajeev has 20 years of Fixed Income experience. Prior to joining KeyBank, he was Head of Fixed income at Foresters Investment Management Company. He served as the chief corporate bond strategist and lead portfolio manager responsible for all corporate bond exposure across the mutual fund and life insurance suite of products. As Director of Fixed Income and overseeing managed fixed income and money market funds he was instrumental in launching a short duration bond strategy, co-manager on the Limited Duration Bond Fund, and the Total Return Fund, a mixed asset allocation fund.

Rajeev also brings prior experience as senior credit analyst at Lazard Asset Management, and associate director of corporate ratings at Standard & Poor's Rating Services.

Rajeev received his Bachelor of Science degree in Electrical Engineering from Drexel University, a Master of Science degree in Electrical Engineering from the University of Pennsylvania, and an MBA from Cornell University.

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