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The Pros and Cons of “Green” Bonds

It is a smart idea. A growing number of investors wish to make profits and do good at the same time. They want their portfolios, or part of their portfolios, to be “ESG”—that is, to support environmental, social, and governance causes. Why not promising them that, if they buy your bonds, the money will be used to, for example, install solar panels? Why not showing that their investment will have a positive “impact” on, say, the climate? This should expand the pool of buyers interested in the bond, make borrowing cheaper, and burnish the reputation of everyone involved. That, in essence, is the insight behind “green bonds”. Or “social bonds”, to help the poor. Or “blue bonds”, to protect coral reefs. The possibilities for these thematic bonds are endless. By some estimates, $200 billion of them were issued just last year. But, does it all pan out in practice? Well, there are pros and cons, and there is evolution.

Start with the downsides. First, green bonds are actually not cheaper—you do not save by promising to use the proceeds in a certain way. Why? Because investors look at how likely you are to pay back—your “credit rating”—to tell you what interest rate they will charge you. Whether you spend on solar panels or oil drills does not change your creditworthiness, at least not in the short-term.

Second, money is fungible. You may think that you are financing the purchase of solar panels but, if the borrowing government or corporation already has the money to pay for those panels, you would be freeing its own resources to do something else. Green bonds may in fact finance national monuments or company cars. Hopefully, they won’t. But you cannot rule it out if you do not see the entire expenditure plan of the borrower, before and after you lend. This comprehensive reporting can be time-consuming and pricey.

Third, the combination of promises to bond buyers and fiscal austerity may have ugly unintended consequences. A government may commit to larger spending on a worthy item, like cleaning up polluted beaches. But, if it also has a ceiling on its budget deficit—which it may need to keep the economy in order—, forcing more expenditure on beaches could come at the cost of cutting down on, say, sanitation. Whether that trade-off is right or wrong is better decided by parliamentarians, not financiers.

Fourth, it is not easy to identify “impact”. Even when the proceeds of a bond can be shown to increase a particular expenditure (bonuses for exceptional teachers, for instance), proving that the extra spending has a desired impact (better test scores among students) is complex. You need experiments and control groups. Proper evaluations take time and money, and the results may be disappointing or may not be available before the bonds come due. Will investors then feel let down and

close their checkbooks next time around or, worse, sue? This writer has found no record of bond-holders taking a country or a firm to court for defaulting on spending pledges. But it is technically possible.

Fifth, over time, linking bond proceeds to specific public expenditures—a.k.a. “ear-marking”—can lead to more expensive funding, or even under-funding. If purpose-specific bonds proliferate, investors will be able to pick and choose what part of the fiscal budget they finance. Schools, hospitals, and road maintenance may be popular. But, who will want to fund tax collection, regulation, and prisons? Shouldn’t those less desirable bonds pay a higher return? Not clear.

So, if price, fungibility, austerity, identification, and ear-marking are such a problem, why bother with thematic bonds? Two words: signaling and diversification. When a public official or a private CEO goes through the trouble of committing to a certain additional expenditure, they are telling the world how much they care about it, and how ready they are to make it a priority. They are also speaking of budget stability: this one item will not be cut during rainy days. And they are implicitly accepting scrutiny in everything else they do—transparency spills over. All this is usually part of a broader strategy—protecting the environment in the case of green bonds. It is an effective way of using finance to drive policy.

Note that the signal of commitment helps mobilize others to the cause. Multilateral organizations like the World Bank find this quite useful. Their very existence is based on a “theme”—ending poverty through sustainable development, in the case of the Bank. Their internal systems are set up for evaluation and public accountability. When they issue bonds, the proceeds can easily be associated with thematic results. This gives investors a ready-made supplier of impact.

Which brings us to diversification. As more and more bond buyers vie to be—or to be seen as—ESG friendly, they become an alternative source of funding for borrowers able to act on the ESG agenda. It is not a small alternative: since the creation of the United Nations-sponsored “Principles for Responsible Investment” in 2006, the number of global financial institutions who are signatories has grown twenty-fold, to over 2,000. They have some $80 trillion in assets under management.

With those pros and cons in mind, are these bonds something you would recommend for the average government, company, or institution? Yes, with three provisos: keep them to a small proportion of your total financing, use them only for things that are really important to you, and be alert to the evolution of this market. The cost-benefit analysis of tapping this type of finance will progressively tilt in its favor. From design to disclosure, common standards will arise and investors will feel more comfortable with them. Some functions will be taken over by specialists—one day, credit rating agencies may issue “green ratings”. Valuable track-records and brands will be built. Better to stay tuned.

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