Green bonds usher in a new era of environmental finance, TD Economics

TORONTO – Green bonds are emerging as a frontrunner to fund environmental investment and have garnered a considerable amount of attention from both investors and environmentalists, states TD Economics in a special report released today.

There is a desperate need for funding of environmental initiatives, and the reality is that governments around the world lack the financial resources to meet all of the current and future requirements. The natural solution is to attract private sector investment into environmental initiatives, and one way to accomplish this is to issue debt instruments, particularly bonds, with the raised capital dedicated to the initiative.

Defining the space

"Green bonds are like victory bonds for the environment," said Craig Alexander, Senior Vice President and Chief Economist for TD Bank. "With their exclusive focus on supporting green initiatives, they are a good way to secure large amounts of capital to support many different environmental investments – from renewable energy technologies to public transportation – as was seen with this week's green bond announcement from the Ontario government."

While similar in many ways to traditional bonds issued for general corporate use, green bonds differ in that they are monitored to ensure funds are being used to exclusively support environmental projects. This monitoring process is transparent and made available to investors.

Investor profile

Institutional investors – such as pension funds, mutual funds, insurance companies and sovereign wealth funds – are the natural market for green bonds. These investors hold about 72% of long-term investment in the global bond market, and have significant portfolio requirements for fixed-income investments.

However, green bonds also have a broad appeal, albeit on a smaller scale, with retail investors who have indirect exposure to bonds through pension and mutual fund holdings. A case in point, some green bonds issued abroad have experienced demand from households. Indeed, a World Bank issue of green bonds was targeted specifically at Japanese individual investors.

Future potential

The outlook for green bonds is very promising. Demand for green bonds is significant and has been growing rapidly over the past six years. Current estimates place the value of the green bonds market between US$10-346 billion – a broad range due to various definitions adopted and the absence of a standardized format.

Investing in environmental projects can often be lucrative for investors. Many green bonds are deemed low risk because they are issued with strong credit ratings and they often generate a higher return than traditional benchmark bonds. In light of the relative outperformance, investors are finding that going green is win-win – it's good for both the world and their wallets.

One issue the green bond market today faces is a lack of standardization in definitions, format and projects, making assessing its size problematic. But even using the broadest definition, the green bond is small today but has great room to grow.

“Current definition challenges should be conquered as the green bond market matures and grows,” concluded Mr. Alexander. “That being said, structure and return will remain the key considerations for continued success and increased demand.”

To read today’s report, titled “*Green Bonds: Victory Bonds for the Environment*,” please visit td.com/economics under November 1, 2013.

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