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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 recently 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 part of the overall municipal bond market issuance, but have recently gained significant traction. Since the Commonwealth of Massachusetts' inaugural $100.0 million Green Bond issuance in 2013, municipal Green Bond issuance grew to $2.9 billion in 2014 and jumped 48 percent to $4.3 billion in 2015.[1] While the year-over-year percentage growth in Green Bond issuance in 2015 was strong, $4.3 billion in total Green Bond issuance remains a small (1.1 percent), although growing, part of the new-issue municipal market (total issuance was $397.7 billion in 2015).

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]Thomson Reuters as of December 31, 2015.

Inside:

By: Christine LaFrance
Associate

Elizabeth Hanify
Vice President & Manager

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The Municipal Bond Market

The $3.7 trillion[2] U.S. municipal bond market 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 70 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.

What Are Green Bonds?

Green Bonds are issued specifically to fund environmentally beneficial projects such as renewable energy, green infrastructure, clean water, waste management, and eco-friendly transportation. Green Bonds are traditional municipal bonds, except that the bonds' proceeds are:

- Used for environmentally beneficial projects,
- Identified or defined as green (usually in the official statement), and
- Monitored and reported on in order to ensure proper green use of 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.

The difference being that Green Bonds' proceeds are earmarked for environmentally beneficial projects.

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.

[2] "US Bond Market Issuance & Outstanding," Securities Industry and Financial Markets Association (SIFMA). Outstanding municipal debt as of Q3 2015.

[3] "Holders of U.S. Municipal Securities," SIFMA and the Federal Reserve System. As of Q4 2015.

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.

Large municipal issuers and market leaders, such as the City of New York, have stated that a "high-quality, sustained New York City Green Bond program would benefit both the fiscal and environmental health of the city," citing an increase in environmentally beneficial investments, expanded investor base, and a course to a more sustainable future.[4] We anticipate that other muni issuers feel similarly about the benefits of a Green Bond program.

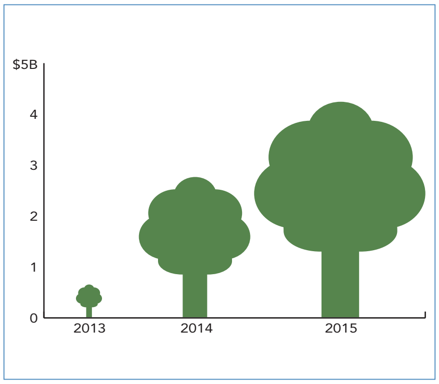
For Individual Investors: Tax-exempt municipal Green Bonds present an opportunity to earn tax-exempt income in conjunction with an environmentally focused investment. In addition, thus far, Green Bond issuers have provided additional ongoing information regarding the underlying green projects to confirm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

Growing Issuance Levels:

Since Massachusetts' initial green transaction in 2013, the municipal marketplace has seen significant growth in Green Bond issuance, totaling $7.9 billion. 2015 proved to be a breakout year for Green Bonds with 34 transactions coming to market, doubling the transactions issued in 2014. Since the inaugural transaction in 2013, Green Bonds have been issued in 21 states and the District of Columbia.[5]

Green Is Growing

Annual Green Bond Issuance



Source: Thomson Reuters as of December 31, 2015.

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.

Importantly, as with all municipal bonds, municipal Green Bonds must be issued for qualified capital projects. The difference is that the qualified capital projects that municipal Green Bonds are issued for must also serve an environmentally friendly purpose, but this definition can vary.

While certain issuers, nonprofit organizations, and banks, have come up with their own Green Bond criteria, a standard industry-wide framework has not yet been established. The lack of a universal set of "Green Bond Guidelines" leaves room for different shades of green.

[4] "Update: A Green Bond Program for New York City," April 2015.

[5] Thomson Reuters as of December 31, 2015.

For example, the Commonwealth of Massachusetts, the District of Columbia Water and Sewer Authority, and the Metropolitan Transportation Authority ("MTA") each employed different methodologies to support their offerings' greenness:

- The Commonwealth of Massachusetts developed its own "environmentally beneficial" green categories and methodologies leveraging Federal and State standards to "balance sustainable economic development, quality of life, and the protection of natural resources," as defined in their Green Bond official statements.[6]
- The District of Columbia Water and Sewer Authority commissioned an independent opinion on the sustainability credentials of its Green Bond transactions from a sustainability consultant, who based the analysis on an independent assessment methodology.[7]
- The MTA had its 2016 Green Bond transaction designated as "Climate Bond Certified" by the Climate Bonds Initiative, based on "international standards for climate integrity, management of proceeds, and transparency."[8]

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.

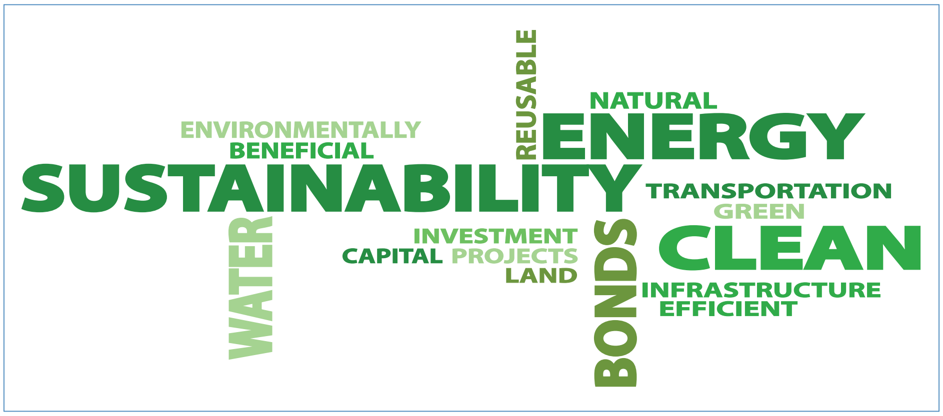
Risks and Considerations: Is the Grass Greener?

Environmental infrastructure projects funded by municipal Green Bonds will likely 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 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. As the municipal Green Bond market develops, increased awareness and standardization could further growth potential and encourage additional municipalities and investors to go green.

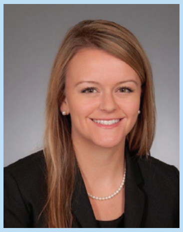


[6]The Commonwealth of Massachusetts, General Obligation Bonds, Consolidated Loan of 2014 Series E (Green Bonds). http://emma.msrb.org/IssueView/IssueDetails.aspx?id=EP365849

[7]District of Columbia Water and Sewer Authority, Public Utility Subordinate Lien Revenue Bonds Series 2015A (Green Bonds). http://emma.msrb.org/IssueView/IssueDetails.aspx?id=ER372002

[8]Metropolitan Transportation Authority, Transportation Revenue Green Bonds, Series 2016A. http://emma.msrb.org/IssueView/IssueDetails.aspx?id=ES360497

Authors:



CHRISTINE LAFRANCE
Associate
Municipal Finance

ELIZABETH HANIFY
Vice President & Manager
Municipal Finance

FIDELITY CAPITAL MARKETS
200 SEAPORT BOULEVARD
BOSTON, MA 02210

Material Referenced:
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Fidelity Investments, Fidelity Brokerage Services LLC, Member NYSE, SIPC, 900 Salem Street, Smithfield, RI 02917

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