

Funding Mechanisms in Green Finance: The creation of commitment with Green and Sustainability-linked Bonds

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April 25, 2023

Abstract

I study a problem of moral hazard in corporate funding which arises due to the time lag between funding and investment. The investors decide at which funding terms (e.g., at which bond price) to invest in the company before the company has to decide in what projects to invest the funding amount. I show that if investors with green preferences participate in the funding process, the company can benefit from committing to invest in green projects ex ante. Moreover, the company's commitment gives investors with strong green preferences a competitive advantage over the other investors in the funding process. In Green Finance, companies can create commitment by the issuance of specific bonds. They can either ring-fence the funding to a pre-defined project (i.e., *Green Bonds*) or create financial incentives by linking the coupon payments of the bond to a specific sustainability target (i.e., *Sustainability-linked Bonds*). If the project's sustainability is observable by the investors ex ante, both bond types yield the same outcome. However, if investors can only observe the project's sustainability ex post, some companies may be able to assign a *fake* label to the project. In a market with both *fake* and *honest* companies, information asymmetry with regard to the sustainability of the project is created. While *Sustainability-linked Bonds* prevent *fake* labels by making the sustainability target verifiable ex post, the

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outcomes of *Green Bonds* are distorted due to the information asymmetry. I show that *Green Bonds* yield more investment in green projects compared to *Sustainability-linked Bonds*. Hence, a regulating authority which is primarily concerned in a high sustainability impact has no incentive to prevent all companies from *faking* the label. Moreover, I show that investors with strong green preferences benefit from *fake* labels since their competitive advantage increases with the commitment to green projects.