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Municipal Basis Points – Weekly

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Municipal Market Comments

Munis And ESG Go Together Like A Horse And Carriage

For those of our readers trying to identify the inspiration for the title of this week's ***Municipal Basis Points***, we can thank none other than "Ol Blue Eyes" and the "Chairman of the Board" himself, Frank Sinatra. Sinatra first recorded ***"Love and Marriage"*** in August, 1955 and at the risk of losing part of our audience, many of us recognize this memorable tune as the theme song for the iconic sitcom ***Married With Children*** which ran on TV for 11 seasons through 1997. Who could forget that infamous shoe salesman Al Bundy and all of his classic insults? Truth be told, we could easily take up full real estate this week just by recounting some of our most favorite episodes, but one would have to question the appropriateness of taking these liberties in such a serious publication. In any event, thanks for humoring us.

So as the investment narrative across multiple asset classes continues to focus upon what appears to be the formulation of a comprehensive infrastructure initiative of historic proportion, we have to believe that there exists the potential for more activist participation from the Public Finance community and the Municipal Bond market. Referring back to our 2021 Outlook, we posited that ESG factors will take on greater significance in 2021 and beyond with climate change and threats representing a growing investment consideration for those affected areas of the country. ***Over the past decade we have seen an expanding interest from the municipal securities investor base in ESG bond programs and we suspect that this trajectory will continue.*** A 2019 survey conducted by the ***Morgan Stanley Institute for Sustainable Investing*** revealed that about 85% of U.S. individual investors and 95% of Millennials expressed interest in various sustainable investment strategies.

With a far broader application of an infrastructure agenda, opportunities to pursue a sustainable investment discipline rooted in the tenets of environmental, social, and corporate governance ideals align quite nicely with the positive societal impact that has provided the historical framework for the contributions advanced by the municipal securities asset class, which as we know serves the overall "greater good". Of course, ***the varied definitions of ESG investing does create confusion and so it is important to consider specific investment objectives and suitability needs across investor classes.***

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In the most intuitive sense, municipal bonds are issued to provide cost-efficient funding for essential purpose, bedrock projects that help to support community advancement and economic expansion, with perhaps capital investment targeted closely towards underserved populations. Thus, ***ESG investment may focus upon demographic patterns and shifts that reflect varying societal attributes from one economic group to another.*** Sustainable investment criteria has become integrated into the municipal credit review process where a disciplined fundamental analysis covering a wide range of traditional financial metrics is applied and ***as the investor audience for municipal bonds continues to broaden, both taxable and tax-exempt ESG investors can capture the above average credit quality and portfolio diversification attributes offered by municipal bonds.***

One growing area of the municipal bond market with a commitment to ESG investing is found with "Green Bonds", a type of security that specifically dedicates funding for infrastructure projects in support of climate and environmental improvements and benefits such as clean and energy-efficient power, renewable energy projects, safe drinking water initiatives and pollution prevention and control. Undoubtedly, ***climate change issues represent one of the key drivers of an eventual infrastructure package and we see this as expanding fertile ground for "Green Bond" issuance.***

It is important to note that ESG investment is not solely comprised of "Green Bonds", yet we point out that specifically dedicated "Green Bonds" are becoming more and more part of the Muni vernacular. Various types of public education, public power (renewable energy), affordable housing and not-for-profit healthcare (earmarking for charity care) revenue bonds can meet the standards for appropriate ESG investing. ***Climate change risks are becoming a more primary investment consideration and we are seeing a broadening application of bond proceeds to combat these risks.***

The risks associated with all-encompassing wildfires and hurricanes are gaining attention with a number of issuers altering their capital plans and this would represent an appropriate application of "Green Bond" proceeds. According to the National Oceanic and Atmospheric Administration, the United States encountered 22 billion-dollar disasters at a total cost of $95.8 billion in 2020. From 2018-2020, there were 50 billion-dollar disasters with an aggregate price tag of $236.6 billion. While it is true that natural-disaster-related municipal bond defaults do not occur, with credit downgrades being a rare event, and that we may experience an administrative glitch that may temporarily delay debt service payment, certain weaker credits may encounter undue downward pressure. In these situations, it is important to understand an issuer's pre-disaster credit profile in terms of budgetary flexibility, reserve balances, liquidity, and historical management responsiveness.

For most impacted municipal issuers, adequate financial resources and capital market access alleviate the immediate revenue disruption and overall credit burden brought about by a disastrous climate event. Although Presidential emergency declarations can create a pipeline of FEMA aid, the timing of such funding is often variable with ultimate receipt of fully promised aid not necessarily a guarantee. Furthermore, FEMA cannot address the risks, such as outmigration, employment opportunities, and future regulatory mandates, associated with major climate events. Other issuers may find a more challenging budgetary formation process as they prepare for climate risk mitigation and regional cooperation across multiple municipal governments and enterprises would significantly help to address the growing risks of climate change.

Bond disclosures are improving with respect to climate conditions and remediation activity, yet transparency remains uneven and we must think about the frequency of "boiler plate language". The occurrence and magnitude of natural catastrophes have elevated the call for preparedness and questions the availability of adequate financial resources to address such events. Various issuers of "Green Bonds" have made available in their disclosures an independent verification of the project's environmental impact.

The Federal Reserve has been identifying climate change as a clear and present threat to the U.S. economy for some time now with policymakers voicing their concern over wealth destruction, a further distortion of existing income inequalities, and even the potential for a permanent displacement of area residents. In our view, the Fed's thoughtfulness dovetails well with the Central Bank's dual mandate of price stability and full employment as well as with its concerns for the well-being of our financial system. Federal and state policies that are crafted to mitigate climate change are likely to impact prices, productivity, employment, and output with potential implications for monetary policy.

As part of our ongoing credit analysis, governance and the ability to respond in a timely fashion to a crisis situation have always been part of the process, but now these considerations can have a greater influence on liquidity and pricing for a broadening array of securities. Rating agencies are incorporating ESG considerations such as climate risk into their overall scorecard methodologies and weighting assessments and have placed various issuers on notice that further disclosures are required. ***We suspect that demand from the institutional buyer base may be a driver of better disclosure and transparency and that over time perhaps the market will do a better job pricing in high levels of climate change risks, yet we think that existing technical factors likely mute such credit distinctions for now.***

According to the MSRB, the first municipal bond issued with a "Green Bond" designation was a $100 million Commonwealth of Massachusetts loan sold to fund various improvements to water quality, energy efficiency and pollution control. Bloomberg tracks "Green Bond" issuance and since 2013 there has generally been visible advances with "Green Bonds" accounting for about 3% of aggregate issuance in 2020. ***While growing in our popular municipal nomenclature, the "Green Bond" designation presently lacks a universally accepted market standard or definition according to the MSRB; perhaps this is attributable to the potentially broad environmental or societal impact.***

The MSRB, however, points out the existence of internationally recognized standards and certification protocols, such as the globally acknowledged Climate Bond Standard and Certification, that when properly adhered to by issuers, can offer investors a more vivid consideration of the "Green Bond" designation. The Green Bond principles (GBP) are voluntary best practices guidelines that, according to the MSRB, "are intended to provide issuers with guidance on the key components involved in issuing a green bond, to aid investors by promoting availability of information necessary to evaluate the environmental impact of their green bond investments and to assist underwriters by encouraging a disclosure standard that would facilitate green bond issuances."

GBP helps to facilitate the underwriting and investment process. With transparency, accuracy and quality of information, it is much easier to disclose the environmental impact of those projects financed with a "Green Bond" designation. Investors can assess the four core components of the GBP: use of proceeds; process for project evaluation and selection; management of proceeds; and reporting on use of proceeds and project impacts and benefits.

Independent, third-party auditors, legal counsel, and other expert institutions may be engaged to opine upon an issuer's "Green Bond" program as a way to help sync up the selection criteria for "Green Bond" projects with climate and environmental analysis as well as with the consistency for relevant standards applied to eligible projects. Furthermore, these parties help ensure that the associated projects align with proper investment categories generally identified to respond to specified environmental problems as well as affirm whether or not issuers have suitable governance structures with adequate guidelines and systems along with responsive and remedial expertise.

The MSRB points out that there are state and local bond issues that are tied to environmentally sustainable activities, yet do not adhere to the core components of the GBP or the Climate Bond Standard and Certification framework. Here an example may include a bond issued by a state or local governmental agency created to oversee and manage water and wastewater, public transportation and similar projects.

The MSRB discusses "Greenwashing Risk" as the risk that bond proceeds from an issuance marketed as a "Green Bond" are not applied to eligible projects, exposing both issuer and underwriter to potential reputational risk. More to the point, in the absence of a universally accepted definition of what denotes a "Green Bond", the risk of not being "sufficiently Green" may be always present. The MSRB goes on to say that the use of bond proceeds for green projects does not generally create a contractual obligation with bondholders, thus giving investors limited recourse if the intended investment objective is not achieved.

As part of their overall evaluation of ESG attributes, Moody's and S&P have crafted their own "Green Bond" assessment methodologies. ***Importantly, the assessments are not credit ratings and are not a determinant of credit quality. Rather, they offer a relative scoring taking account of governance oversight, administration, execution, monitoring, reporting and remediation attributes tied to the use of bond proceeds for a specific "Green Bond" financing.*** The Bond Insurers are also advancing their own contributions. Build America Mutual continues to expand its "GreenStar" assessment program as it provides a third-party verification of a bond issue's conformant with the International Capital Market Association's Green Bond Principles.

Moody's defines "Green Bonds" as "fixed income securities, both taxable and tax-exempt, that raise capital for use in projects or activities with specific climate or environmental sustainability purposes. These include debt obligations with direct recourse to issuers, project finance or revenue bonds with and without recourse to issuers, and securitizations that collateralize projects or assets whose cash flows provide the first source of repayment".

The Moody's assessment, which specifically evaluates the relative probability that bond proceeds will be invested to support environmentally beneficial projects as designated by the issuer on a more granular and transparent basis, will score each bond issue on five key factors (along with respective sub-factors that are also scored) weighted to reflect their relative importance, to determine a composite grade. The five key factors and their respective weightings are: (1) Organization (10%); (2) Use of proceeds (40%); (3) Disclosure on the use of proceeds (15%); (4) Management of proceeds (15%); (5) Ongoing reporting and disclosure (20%). The composite grade is used to yield an overall assessment that runs from 5 (excellent) to 1 (poor). ***Once a Green Bond assessment is initially established, it is subject to periodic revision given subsequent information provided by an issuer in its annual disclosures.***

S&P's Green Evaluation offers a relative green impact score for financial instruments that target the financing of environmentally beneficial projects and is intended to raise the level of transparency as to how the rating agency conducts Green Evaluations. Upon request, the assessment offers a second opinion on a particular transaction's adherence to Green Bond Principles or to the Green Loan Principles. Governance and transparency are the first considerations when reviewing a financing with this assessment combined with an estimate of the asset's expected lifetime environmental regional impact, thus making for a "point-in-time" evaluation.

Through S&P's analytical framework, mitigation and adaptation projects can be evaluated. Mitigation projects are intended to create environmental benefits and generally involve depletion of natural resources, loss of biodiversity, pollution control, and climate change. Adaptation projects would typically lower exposure to and manage the impact of natural catastrophes. As an example, communities and critical infrastructure would be made more resilient to the risk of extreme climate change – induced weather events. Thus, the S&P Green Evaluation reflects three scores – transparency, governance, and mitigation (environmental impact) or adaptation (resilience level), with a final composite Green Evaluation scoring methodology on a scale from 0 - 100 and from E1-E4.

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