

Bond Case Briefs

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As California Rebuilds, What Do Growing Wildfire Damages Mean for Muni Bonds?

As communities in Los Angeles and San Diego counties begin to recover from the devastation, we examine the impact of California wildfires on municipal bonds and discuss how active management can potentially help mitigate climate and environmental risks.

The destruction caused by the recent Southern California wildfires is [estimated](#) to be one of the costliest natural disasters in U.S. history, with projected property and capital losses ranging from \$95 billion to \$164 billion. This staggering figure far exceeds the \$16.5 billion cost of the 2018 Camp Fire, which devastated about 90% of the town of Paradise and was previously the most expensive wildfire disaster on record. As assessments of the damage continue, these updated estimates underscore the ongoing process of evaluating the immense scale of the destruction.

While the personal losses and community impacts are profound, we expect that municipal bondholders are likely to be relatively insulated from any financial damage. Former President Biden's declaration of the affected areas as a disaster zone makes these communities eligible for FEMA funding, which can cover approximately 75% to 90% of recovery costs.

However, federal funding can take time to reach affected areas. In the meantime, municipalities typically rely on their own resources along with early state assistance to support and fund initial response efforts. Despite the challenges, the availability of federal aid serves as a financial lifeline, enabling communities to begin the process of rebuilding and recovery.

What areas of the municipal bond market have been affected?

While we don't anticipate material credit impacts for the city or county overall, there is potential for risks for areas with more limited assets or tax bases. As the second-largest city in the United States, Los Angeles has a strong credit profile and is well positioned to withstand the financial impact of the wildfires.

The Los Angeles Unified School District (LAUSD) faces significant exposure to loss and property damage and will likely rely on support from both the city and the state. However, LAUSD maintains a strong Aa2 credit rating following an upgrade in 2024 and has shown consistent financial stability due to strategic planning and conservative budgeting practices. As such, the LAUSD fund balance is robust, and can help provide the district with the financial flexibility to navigate through the rebuilding process effectively.

In contrast, municipal bonds backed by Tax Increment Financing revenues or tied to single assets, such as nursing homes or charter schools, may encounter more financial difficulties. These entities often face greater risks due to their reliance on a specific revenue stream, which can be less predictable in the wake of a natural disaster.

Bonds issued by the Los Angeles Department of Water and Power (LADWP), the largest municipal utility in the United States, were also affected by the recent wildfires. As the fires raged, the spreads

on these bonds widened as investors became concerned that the fires may have been caused by LADWP's power system equipment. Although there's no evidence to suggest that LADWP is at fault, utility companies have been found liable for causing fires in California, Hawaii, and Washington in recent years.

Is the risk of natural disaster priced into the municipal bond market?

As climate-related events increase in frequency and severity, there's [research](#) to suggest that these risks aren't yet fully reflected in the municipal bond market. Since municipal bonds are often used to finance infrastructure and other public projects, the financial stability of the issuing municipalities is of key importance and can be threatened in the event of a natural disaster.

Historically, no municipal bond issuer has ever defaulted due to a climate-related event. However, we do believe that this is a risk that needs to be considered, especially given growing concerns about the willingness and ability for insurers to cover growing losses. This factor underscores the importance of active management, where in-depth, bottom-up research can add value by integrating climate risk analysis into the security selection process.

Mitigating risks in municipal bonds with active management

Natural disasters and climate-related events are difficult to predict, but active managers can assess these risks by evaluating an issuer's level of preparedness to recover from such events. This analysis may lead them to pass on a specific name or demand a wider spread to compensate for this risk.

Considering the role of municipal bonds in financing recovery efforts, we believe this approach is essential as regions with a higher likelihood of experiencing these events may increasingly depend on such funding. This approach can potentially help to protect investors while also supporting communities in building resilience against the growing financial challenge presented by these climate-related disasters.

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