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Environmental Risks Becoming Part of Bond Assessments.

Municipal bond investors have started asking governments to disclose their area's environmental hazards, but a lot of the information they want is not yet known.

Each spring the city of Orting, Wash., is the final stop on the Daffodil Festival Parade. Against the expansive backdrop of Mount Rainier, this town of 7,000 puts on a wonderful show that earned it the nickname "Small Town, Big View."

In all this bucolic delight, it's easy to forget that at any moment Orting could be wiped off the map. Mount Rainier is an active volcano. When it erupts, the resulting crush of lava, mud and glacial ice will bring disastrous problems for Orting and every town nearby.

This is no secret. In fact, in a recent bond offering document, Orting quoted the U.S. Geological Survey's (USGS) assessment that "over the past 10,000 years Mount Rainier has been the source of numerous volcanic debris flows that buried now densely populated areas as far as 100 km from the volcano." USGS also says it's not possible to predict the next eruption. So for now, folks in Orting will focus on the daffodils.

A statement about volcanoes might seem out of place in a financial report. But, in fact, this statement and many others like it are a direct response to specific questions posed by bond investors and other financial stakeholders. They use this information to measure and "price in" the potential for volcanoes, hurricanes, earthquakes and other discrete, catastrophic events. Their analysis matters a lot. For example, some academic papers have shown that, when they sell bonds, communities in California most vulnerable to earthquakes pay up to millions of dollars more in extra borrowing costs.

More recently these financial stakeholders have started to push the boundary for what we can reasonably include in a government financial statement. They have started to call for a new type of information about other environmental risks that are far more abstract and systematic. For state and local governments, these new demands present some big and immediate challenges.

Climate change is a prime example. At a recent industry conference, a panel of municipal bond investors and credit ratings experts outlined a sort of wish list of information that states and municipalities ought to share about the financial implications of future climate change. These investors are especially interested in the deleterious effects of rising water levels. Sewer systems, after all, run on gravity. If water levels rise, less water flows downhill, and that can render an entire sewer system useless. It makes sense that water and sewer bond investors would want to know if climate change might cripple their investment.

It doesn't stop with too much water. These same stakeholders have publicly called for better disclosures about the financial implications of prolonged droughts. Others want cities to speculate on how a massive conversion to solar energy might fundamentally alter urban infrastructure needs.

This appetite for information is more than understandable, but it also presents several problems for state and local governments. First, a lot of this information is unknowable. Scientists mostly agree about the likelihood and eventual effects of one-off catastrophic events like volcanoes and earthquakes. But at the moment they don't really agree on how, when and where climate change will happen, and how it will ultimately shift weather patterns, raise sea levels and melt glaciers. The science gets better every day, but for now these sorts of massive changes are difficult to understand and predict.

Moreover, if a government wants to disclose these risks it must exercise proper internal controls on how it carries out that risk assessment. These controls require a clear procedure to separate the "relevant" risks from the "nonrelevant" ones. Of course, this is difficult to do when the risk assessment is based on mathematical models that can reach qualitatively different conclusions if the assumptions change. Once a government discloses this information, citizens naturally start to wonder why their state or city isn't doing more to prepare for the eventual problems and other systemic threats related to climate change.

The beauty of budgets and financial statements is that they make abstract things real. But for that to work, those abstract events must be grounded in at least a little bit of empirical reality. Right now, there's no such reality for the information investors want the most.

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