

# Bond Case Briefs

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## The Muni Bond Market's Biggest Credit Risk: Climate Change.

**The risk isn't priced into bonds yet, but 2020 could change that.**

The municipal bond market has staged a strong, somewhat unexpected rally in 2019, but faces growing risks from climate change, according to a growing number of investment firms.

"Extreme weather events pose growing risks for the creditworthiness of state and local issuers due to impact of those events on local GDP which could reduce GDP growth of affected metropolitan areas by 0.5% to 1%," BlackRock has warned.

Moody's climate intelligence unit, Four Twenty Seven Inc., in which it holds a majority stake, reports that rising temperatures, "if significant enough, now and over the ensuing decades ... have the potential to lower revenue, increase expenses, impair assets and increase liabilities and debt."

The impact, of course, will depend on the strength of the economies affected and the costs of emergency responses and mitigation efforts, but the growing risks are something that all municipal bond investors, analysts and portfolio managers have to think about to a greater degree than previously, says David Alter, a portfolio manager and co-head of municipal bond research for Goldman Sachs Asset Management.

"The wildfires have drawn a lot of attention to the impact of climate change on muni bonds," says Alter. "In the case of California the power industry is now under pressure with its survival at risk."

California's biggest utility, PG&E, has filed for bankruptcy and undertaken mandatory rolling blackouts as a result of the growing number of wildfires. It now faces a "safety crisis" and may not survive in its current form, according to a recent Wall Street Journal story citing safety specialists, researchers, former regulators and other experts.

Despite these risks in California and in other states and municipalities affected by more devastating fires, floods or extreme heat, muni bond prices have not been affected significantly. "The marketplace has not discounted" these risks in places where it probably should, says Alter, adding that the rating agencies also are not doing enough analysis of the climate risks that municipalities face.

"Ratings agencies talk about climate risks, but I'm not seeing that reflected much in their ratings or views on securities packages," he says.

2020 could be a turning point, however. It could be "the first time [that] climate change risks will be priced into some bonds ... the most directly affected bonds," says Matt Fabian, a partner at Municipal Market Analytics. "There is so much pervasive interest in climate change risk in the muni industry on the asset management side that it's only a matter of time when it becomes apparent in prices."

Most at risk are localities that are already economically challenged, located in low-tax states and threatened with extreme weather-related events. In contrast, “big city bonds are going to be protected by big states,” says Fabian. “There are literally no costs that New York State won’t pay to protect New York City ... which is likely to be safer than small cities near the coast in New Jersey or Connecticut.”

He recommends that investors swap out of bonds issued by governments in areas most exposed to climate change risk, such as the coasts of Florida or the Carolinas, and into areas with less exposure, whether geographic or economic.

Extremely tight spreads in the muni market — 35 basis points between a 10-year A-rated revenue bond vs. AAA-rate general bond — make this an opportune time to make the switch, according to Fabian. Investors wouldn’t be giving up much yield to make the change, and tight spreads suggest the change to incorporating climate change risk will happen quickly in the market, rather than gradually, following a dramatic event.

Fabian recommends that investors also learn whether the managers of their funds are truly addressing climate change in their portfolios or just paying lip service to that analysis.

Alter says investors also need to focus on whether the management teams of municipal issuers are able to react quickly to climate events (which also suggests the importance of state governments) and whether local and state governments have the ability to protect local economies and bond markets.

He cites Florida’s legislative response to Hurricane Andrew, which devastated the city of Homestead in 1992. The state created two funds to address the impact on insurance market: a Hurricane Catastrophe Fund to reimburse insurers for a portion of their catastrophic hurricane losses and the Florida Residential Property and Casualty Joint Underwriting Association to provide certain residential property and casualty insurance coverage to qualified state residents.

That had a “huge impact on municipal market there,” says Alter, adding that California now has responsibility to fashion its own “big solutions.” California “passed a number of helpful bills but has not solved its power industry problems.”

The state imposed a one-year ban on insurers dropping customers in or alongside ZIP codes struck by recent wildfires, and it asked insurers to voluntarily stop dropping customers anywhere in California because of fire risk for one year.

“Climate change is likely the biggest credit risk on our sector today, but we’re coming from a place of extreme safety,” says Fabian. The current default rate in the muni market is 0.3%.

## **ThinkAdvisor**

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