Bond Case Briefs

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Emerging Environmental, Social, and Governance Trends in the Municipal Bond Market.

Background

The environmental, social, and governance (ESG) movement has been newly adapted as a best practice for disclosure in the municipal market. ESG encompasses many facets of investing, including investments focused on sustainability, such as a green bond, or social improvement, such as a social bond. ESG provides an expansive framework for viewing both risks and opportunities. It may be utilized as a tool for consideration by issuers, rating agencies, and investors to view existing risk factors through a modern lens.

Green Bonds and Social Bonds

Investors' views of ESG as a broader social movement are represented by the targeted funding of projects that align with specific ESG goals through the emergence and popularization of bond designations, primarily green bonds and social bonds, which are based upon intended project impact. Investors are attracted to these specifically designated bonds because they allow them to better target the impact of their financial investment based upon their personal beliefs and interests. While no formal process for issuing such green or social bonds currently exists, the market has established standards, as published by the International Capital Market Association (ICMA).[1] These standards are fourfold:

1. *Use of Proceeds* for a clear environmental or social benefit;
2. *Process for Project Evaluation and Selection* should be described to the investors;
3. *Management of Proceeds* should be allocated to green or social projects; and
4. *Reporting* annually on use of proceeds to investors.

Additionally, ICMA recommends external review to verify the issuer's green or social claims through second opinion, verification, certification, and/or scoring or rating as a green or social bond.

ESG Disclosure as a Best Practice

According to Moody's, the "ability to address ESG risk will increasingly differentiate credit quality after [the COVID-19] pandemic."[2] The rating agency discusses how in a post-pandemic world, limited resources and an increase for services will challenge the public issuer's ability to operate while maintaining a strong financial outlook. Climate risks, if not addressed and properly prepared for, will likely affect credit ratings in the long term. Issuers need to consider which costs may be deferred and which are most critical, as well as which resources are most critical to ensure disaster preparedness due to increased climate risks, such as extreme weather and increased flooding. The pandemic forced social inequities into public view, especially healthcare and racial inequities. Further, demographic trends may play a role in increasing demands upon the healthcare system, while also potentially reducing revenue for higher education institutions. Such social factors are likely to increase the pressure on governments for more public services and intervention amidst sinking revenues and strained budgets. Governance is key to proper budgeting and financial planning, as well as a mechanism for addressing such climate and social issues.

Recent publications by both the Securities and Exchange Commission (SEC) and the Government Finance Officers Association (GFOA) have signaled requirements for ESG disclosures. On March 8, 2021, the GFOA adopted ESG disclosures as a best practice for inclusion in municipal bond offering documents.[3] The GFOA recommends three elements in crafting a suitable ESG disclosure:

"(1) vulnerability assessment, or recognition of ESG related risks, (2) plans/preparedness for mitigating such risks, and (3) progress updates, including impacts of recent ESG elements/events and how they shape future response."[4]

In a March 11 public statement, Acting Director of the SEC's Division of Corporation Finance John Coates said, "Going forward, I believe SEC policy on ESG disclosures will need to be both adaptive and innovative. We can and should continue to adapt existing rules and standards to the realities of climate risk. . . We will also need to be open to and supportive of innovation – in both institutions and policies on the content, format and process for developing ESG disclosures."[5] As ESG grows in significance in both the corporate and municipal worlds, municipal issuers can look to guidance from public bodies, as well as corporate issuers and filings.

This burgeoning trend in disclosure has not been widely incorporated in municipal offering documents. As such, issuers may struggle to determine the materiality of ESG-related issues and disclosures. The GFOA acknowledges such disclosure should be considered a case-by-case basis based on the characteristics of the issuer, noting: "The key for municipal issuers is to determine which ESG factors are material to their own credit profile and relevant to investors."[6] The GFOA does not provide any standard disclosure language.

Takeaways

Bond markets will likely continue to see a growth in various ESG-targeted bonds, as well as a continued discourse related to ESG issues. Municipal issuers should begin to consider ESG disclosures, if material, as part of their offering documents for the project to be financed, and, more broadly, the ESG factors related to the municipality. Within the ESG risk analysis framework, municipalities and other public issuers must determine which ESG risks or opportunities are material, providing necessary disclosure, but also a mechanism for fostering financial resiliency.

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[1] Green Bond Principles, International Capital Market Association, June 2018; Social Bond Principles, International Capital Market Association, June 2020

[2] Sector In-Depth – Public-Finance-US – 30Oct20.pdf (cdfa.net)

[3] https://www.gfoa.org/materials/esg-disclosure (While the GFOA recommends including ESG disclosure information as part of primary offering documents, it also notes that material factors are already required to be included in such documents).

[4] GFOA, ESG Considerations for Governmental Issuers

[5] SEC.gov | ESG Disclosure – Keeping Pace with Developments Affecting Investors, Public Companies and the Capital Markets

[6] GFOA, ESG Considerations for Governmental Issuers