
Fiscal Justice Rating Firm Will Judge Cities' Inequity Risks.

- **Researcher Activest to weigh credit impact of policing, fines**
- **Racial justice emerging as key theme for ESG-focused investors**

A startup bond rating firm is working on quantifying how much social injustices such as police brutality could end up costing cities and states.

The Fiscal Justice Credit Rating Agency is looking to sell research and ratings to investors one year after the murder of George Floyd in Minneapolis galvanized the Black Lives Matter movement and spurred many money management firms to look more closely at social issues. The debt grader, a new arm of municipal market researcher Activest LLC, plans to start issuing ratings as soon as next month, and will have to persuade bondholders to buy such research even as cases of injustice typically don't hurt bond prices.

But expenses linked to injustice can weigh on a city's budget, strain its finances and erode its economic growth, exposing investors to risk they may not be getting paid for, said Ryan Bowers, a co-founder of the firm. That's happened at least once, when Ferguson, Missouri saw its credit rating cut seven notches to junk in the fallout from the police killing of an unarmed black 18-year-old in 2014. Protests and litigation ensued, and the city had to reduce its reliance on traffic tickets and court fees to help balance its budget after entering a federal consent decree.

"These issues add up," Bowers said in an interview. "They are not small. While a single incident won't necessarily result in a downgrade, they do have a cumulative effect that increases the risk and volatility for bondholders and residents."

Investor Buy-in

Convincing money managers to pay may not be easy. For many cities and states, expenses like police brutality settlements as well as fines and fees that disproportionately burden minority communities may represent a small portion of annual budgets or may not be fully understood.

Bonds and debt sellers rarely take a hit when these problems emerge. When Minneapolis sold bonds in September, for example, months after a city police officer killed Floyd and riots had erupted in its streets, it saw borrowing costs still below the levels it paid in 2019.

And getting investors to pay for analysis in general has proven difficult since at least 2003, when Eliot Spitzer tried to tame conflicts in brokerage research, and is only getting harder after European rules have forced brokerages to separate trading and research costs.

But investors are starting to pay more attention to social issues and their financial implications, both for specialized portfolios of socially responsible investments and for their broader holdings. The major bond grading firms are further along with their efforts to research environmental risks than they are with racial or social issues, said Eric Glass, a portfolio manager and lead on the municipal impact investment policy group for AllianceBernstein LP, which has about $52 billion of municipal assets under management.

Firms such as the Fiscal Justice Credit Rating Agency may be able to fill that niche, according to Glass.

"There's going to be a class of investor that's going to want this information and seek it out," Glass said.

Emerging Issue

Activest was started in 2016 by Bowers and Napoleon Wallace, a former high-yield bond trader at Wells Fargo. They started the firm in wake of their analysis on Ferguson, Missouri. In fall 2020, Activest worked to advise 29 city mayors and budget directors on equitable Covid-19 fiscal recovery efforts with Bloomberg Philanthropies, the charitable organization founded by Michael Bloomberg, founder and majority owner of Bloomberg News parent company Bloomberg LP.

Data and other information about potential social justice problems at cities and states can be hard to come by, while those making budget decisions may not even be thinking about these issues, said Witold Henisz, a professor of management at the University of Pennsylvania's Wharton School. Henisz has been working on a project analyzing the impact of environment, social and governance issues on the municipal bond market.

"This issue is still a new and emerging one in the muni market," Henisz said. "It's not as developed as ESG issues are in equities or corporate bonds."

Injustice can be costly, according to Activest. Municipalities, for example, pay $1.5 billion a year for police misconduct settlements, according to the firm. People of color end up paying around $7 billion in extra fines and fees because of issues including unequal policing, Chelsea McDaniel, a senior fellow with Washington, D.C.-based Activest said during a congressional hearing on April 28. That revenue could disappear if governments embrace more equitable policies.

'Regressive Expenses'

For decades, municipal bonds have helped exacerbate inequality, according to Destin Jenkins, an assistant professor of history at the University of Chicago and author of "The Bonds of Inequality: Debt and the Making of the American City."

"Since racism is structural, then racial, social, and economic justice demand structural solutions across all sectors and markets, including the field of municipal research and the municipal bond market," Jenkins said in an email.

Now, some in the municipal market are paying more attention. S&P Global Ratings is working to make social and racial justice a bigger part of its efforts to evaluate cities' and states' credit profiles, with issuers volunteering more information and its analysts asking more questions, said Nora Wittstruck, the ESG lead for S&P's U.S. Public Finance group.

The firm did cut the outlook for the city of Minneapolis to negative from stable in September, signaling there's at least a one-in-three chance of a downgrade from its AAA credit rating in the next one to two years. S&P cited factors including settlement payments related to George Floyd's death, expenditures for police reforms, and a budget gap created by Covid-19, for example, she said.

Credit Negative

Intense social unrest is a negative for credit, according to an October report from Moody's Investors Service, especially if it leads to long-term costs, tax-base declines or economic disruption. That said, such incidents over the past few decades have generally had a “muted credit impact,” according to the report.

Some local government officials want bond investors and bond graders to pay more attention to social injustice as well. Philadelphia Controller Rebecca Rhynhart and other municipal finance professionals and Pennsylvania elected officials sent a letter in January to S&P, Moody’s and Fitch Ratings, calling on them to look more closely at how equitable city and state revenue collection policies are and how much they rely on fines and fees.

Even if cities’ and states’ expenses from injustice aren’t high in the near term, they can sting in the long run, said Activest’s Bowers.

“These fiscal justice issues have very long tails,” Bowers said. He said that information about such issues is “important for investors who are taking on uncompensated risk.”

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