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Cities and States on the Frontline of Climate Change Aren't Always Upfront about Risks. Does the Municipal Bond Market Care?

Are some of our most popular regions becoming uninhabitable?

In mid-August, as water in the Colorado River dwindled, the Metropolitan Water District of Southern California declared a "water supply alert," asking its 19 million customers to voluntarily conserve water. With many California counties already in a state of drought, mandatory restrictions could be put in place in the coming months, Governor Gavin Newsom said.

A few months earlier, officials in Miami-Dade County made a very different announcement, releasing a splashy "Sea Level Rise Strategy" that attempted to answer the question "how can we gracefully, strategically live with two feet of additional sea level rise?" But one environmentalist told the New York Times the blueprint fell short, offering "just enough to reassure developers that Miami's safe enough to build in."

Across the country, state and local governments are hustling to tackle challenges from changing climate, while simultaneously preparing for things to only get worse. It raises uncomfortable questions: at what point is Miami's waterlogged coastline just too wet? How many 100+-degree days can Phoenix, the country's fastest-growing city for the fifth-straight year, handle?

We're barely prepared for the immediate complications, forget the existential ones, public finance professionals say. Government officials often are loathe to admit the dangers their communities face. There is no standard guidance or regulation on how to document climate risk, let alone mitigate it.

More to the point, anyone looking for discipline from the $4 trillion municipal bond market, which funds state and local governments and their projects, will be disappointed.

"It's just amazing, the power of the (muni-bond) tax exemption and the avoidance of taxes. It's an unbelievable force in America," said Thomas Doe, president of Municipal Market Analytics, a Massachusetts-based provider of muni-bond market data.

"Look at the migration to Florida, Texas, and Arizona," Doe said. "You may be able to live there for a short period of time, but it's not going to be a 20-year experience." He calls it denial: "It won't happen while I'm living there." "I can't believe there will be a day when water won't come out of the tap."

Researchers at the Brookings Institution came to the same conclusion in a working paper published last September.

"In municipal finance, there appears to be almost no meaningful disclosure of climate-related risks," the researchers wrote. "Using some of the latest science projecting spatially resolved potential climate impacts, we show that there is no detectable difference in the level of municipal disclosure between communities most at risk from climate change and those least exposed to physical impacts."

"A central challenge seems to be not analysis but imagination," they add.

It's not just the thousands of ordinary Americans flocking to the "smile states" in search of sun and lower taxes — or the people buying tax-exempt bonds — who add to the risk, Doe says. The entire municipal market makes it possible for people and resources to migrate to areas that arguably may be least prepared to receive them.

Take California's Metropolitan Water. In June, the utility sold $100 million of bonds to refinance some that had been issued earlier. It has $2.6 billion in bonds outstanding, which carry the top possible rating from the two largest rating agencies, Moody's and S&P Global.

Metropolitan does note the risks posed by climate change, from flooding that puts pressure on its infrastructure to drought that may limit its supply, in its bond offering statement. But it adds, "Metropolitan is unable to predict with any certainty how climate change will ultimately affect Metropolitan or State water supplies or whether Metropolitan will be required to take additional mitigation measures."

In early August, some of the bonds maturing in 2033 traded at 140.67, well above par — the 100 price typically due at maturity — in a sign investors will are willing to pay handsomely to look past all that uncertainty for the next 12 years.

"These risks are not incorporated in the municipal market. At all," Doe told MarketWatch. "Because investors want the tax exemption, they're not saying 'no' because they want the product. They don't discern risk. It's not a prioritized risk in the ratings. So the rating agencies aren't penalizing the issuer, no-one is telling the issuer you have to disclose risks. No-one wants their cost of capital to go up."

Ratings
The Brookings paper takes aim at the bond raters. While acknowledging that credit firms cannot fully disclose their methodology, the researchers still found what they call big gaps.

Among other things, they note, when Moody's, S&P and Fitch address climate risk, it tends to be backward-looking, rather than proactive. The paper highlighted a 2017 Moody's downgrade of Puerto Rico bonds, as an example: "Hurricane Maria hits in September 2017; the next month Moody's downgrades the (Puerto Rico) revenue bond out of revenue concerns but still makes no mention of climate change affecting the probability of Maria-like events in the future."

"I understand that particular criticism," said Marcy Block, senior director of sustainable finance for Fitch. (Moody's did not respond to a request for comment.)

Fitch does include a climate risk component (called an "ESG relevance score") in all of its ratings, Block said, and some issuers — in the Florida Keys, for example — are graded as higher-risk because of capital needs relating to flooding and other environmental impacts.

"(S&P Public Finance) specifically incorporates an ESG paragraph into our issuer-level credit rating reports and research to provide transparency on how ESG factors may affect a particular entity's credit profile," the credit firm said in emailed remarks. It also discloses if one of its steps was driven by an ESG (environmental, social or governance) factor, the group said.

"There's a recognition that there's still more that can be done," Fitch's Block said. "I think it's clear that the disclosure so far from issuers has been very weak. Whether that's driven by investors continuing to demand more information or regulatory change, I think you'll see more and more disclosure coming forward."

Regulators

Many market participants are hoping for more clarity and enforcement from regulators. In March, the U.S. Securities and Exchange Commission announced an evaluation of climate-change disclosures. The SEC and federal prosecutors have since opened probes into whether a subsidiary of Deutsche Bank overstated its use of sustainable investing criteria, according to a Wall Street Journal report, citing people familiar with the matter.

Enforcement efforts might go only so far. The SEC might look to extract fines from fund managers who make misleading ESG claims or it might go after issuers who knowingly obscure risks. But its role isn't to set standards that will force issuers to identify their risks, disclose them, and get rated on them.

Mark Kim is CEO of the Municipal Securities Rulemaking Board (MSRB), which sets rules around trading and transacting in the muni market but, like the SEC, does not have the ability to set issuer standards. In an interview with MarketWatch, Kim said, "There's certainly more work to be done. I think the market's understanding of climate risk is evolving. Today, reasonable investors consider climate risk to be material."

Ideally, all disclosure would be standardized, not just a reflection of whatever quirks belong to particular issuers, Kim noted, so "investors can compare apples to apples."

Asked whether Congress should amend its charter so the MSRB could make disclosure rules, Kim said, "That's a really important policy question. We will leave it to Congress to decide."

Investors

"We recognize that climate risk is a real threat, it's not just some secular theme that's 10, 20 years out. It's here now," said Sean McCarthy, head of the municipal credit research team for $2.2 trillion money manager PIMCO.

"I think disclosure is the area where people want to see more," McCarthy told MarketWatch. "It's getting better, but it's a risk factor that needs to be discussed. Large borrowers, bellwether borrowers, like the state of California, are pretty good at it. Where it could be better is on the local government level but, there's a cost associated with. I think states could help out a little bit more."

McCarthy also thinks industry-wide standards would be ideal, but like any institutional investor, his team will still do its own credit analysis, he said.

He offered one example: PIMCO rates single-site project bonds in coastal areas lower and demands a slightly higher yield as compensation for taking on additional risk. And he noted that the municipal market broadly agrees, paying less for such bonds than it does for similar inland deals — but only by about 5 basis points.

As previously reported, demand for municipal bonds has run so hot in recent months that it's pushed yields to all-time lows (yields move in the opposite direction as prices) and inflows to mutual and exchange-traded funds have smashed weekly records multiple times in 2021.

MMA's Doe notes a muni-market irony: some of the country's climate-change hot spots, like California and Florida, are also some of the wealthiest, where demand for tax-exempt investments is highest. He believes the municipal tax exemption is one of the biggest reasons the market looks the other way, rather than confronting climate risk.

Issuers

To be sure, plenty of people think the worst-case scenarios people dream up are simply too pessimistic. For example, McCarthy calls the question of out-migration from some of the country's most popular areas "generational."

"I am worried about population trends," he said, but views tax policy as an immediate catalyst of migration trends.

Some municipal officials argue they're far more prepared than the market may realize. Mark Hartman, a Canadian who moved to Phoenix several years to take a role as that city's chief sustainability officer, points out that his adopted hometown has always been a desert, adapting to heat long before anyone worried about manmade climate change.

"People here, it's in their DNA," Hartman told MarketWatch. "Just like the trees here are desert-adapted. We look at innovative projects and policies that will help cool our city."

In a study conducted by Arizona State University, which makes Phoenix a sort of climate-change living laboratory, two city neighborhoods just two miles apart were found to have a temperature difference as high as 13 degrees, pointing to the efficacy of climate mitigation efforts like planting trees, "cool pavement" technology, and more, Hartman said.

But the tricky thing about climate change is that it represents, well, change — not necessarily the same challenges communities faced in the past.

"The latest science about climate change shows the system changing rapidly, with synergistic impacts that will have substantial and growing impacts on physical assets and public welfare, including the economic viability of communities on the front lines," the Brookings researchers wrote.

"Extensions of the latest climate science suggests that plausible tail risks are even larger and more immediate. The problem of disclosure reflects a problem of imagination."

Doe likes to talk about climate risk in three stages: denial, which he thinks we've largely moved beyond, defense, and departure.

We are now in the "defend mode," he said. "There will be rationales made as to why an investment should be made to preserve a community. We'll build gates or drains to protect us. We'll establish resilience committees. But will it be sufficient? Does anyone have the timing right? And then, is that the best use of the money?"

No family likes to prepare for death, but eventually most of us write wills, he said. Similarly, "no-one wants to say a place is going to become uninhabitable."

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