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Does Municipal ESG Make Sense?

Municipal bonds underscore the weaknesses of ESG investing.

The rise of Environmental, Social, and Governance (ESG) investing in corporate securities has reached the municipal-bond markets. But recent experience shows that incorporating ESG factors into municipal investing can be a convoluted, quixotic effort.

While ESG encompasses a wide range of factors, it is the "E" that gets the most attention in the municipal bond market, with climate change being the major concern. When thinking about the role of climate change in municipal finance, we can imagine two issues: (1) Does climate change increase the risk of a municipal-bond default for specific issuers?; and (2) can investors choose bonds that finance projects that provide the largest reductions in greenhouse-gas emissions? Let's consider these two questions in turn.

Climate Change and Default Risk

Unlike corporate equities, municipal bonds offer little financial upside related to global warming. While an equity investor may achieve enormous returns by purchasing shares in a company that invents new green technologies, the best-case scenario for a municipal-bond buyer is the return of principal at par along with interest payments that rarely exceed 5 percent annually.

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