[Bond Case Briefs]

Municipal Finance Law Since 1971

[Climate Change & Muni Bond Insurance.]

Municipal bonds continue to remain a popular way for investors to gain powerful tax advantages and a solid yield. As such, investors of all sizes – from mom & pop portfolios to the largest pension and insurance funds – use them as the cornerstone of their asset mix. Part of their appeal continues to be their conservative nature and the ability of states to tax in order to keep paying the bonds.

However, investors may want to rethink their stance on muni bonds conservativism.

Thanks to new climate change threats, munis may be riskier than we thought. And that newfound risk is now being identified in additional costs to muni bond insurance and credit profiles. For states and municipalities, it could strain their ability to access cheap credit. For investors, it's now an added risk.

Climate Change Risk Enters the Conversation

When PG&E filed for Chapter 11 bankruptcy back in 2019, the Wall Street Journal called it the "first climate change bankruptcy." If you remember, massive wildfires potentially caused by faulty utility equipment destroyed billions of dollars' worth of property. The culprit was an extended period of drought, creating perfect conditions for the fire to spread. While lawsuits and bankruptcies due to environmental negligence have since occurred, it was the first time that climate-specific risks had caused a major financial catastrophe.

Overall, it was a watershed moment for a variety of industries.

Since that time, various agencies and analysts have begun addressing the perils of climate change with regards to their credit ratings. Additional demand from investors looking for ESG requirements have helped spur this along. The staid municipal bond sector hasn't been ignored in this re-rating of assets.

Munis Are Particularly Vulnerable

States and cities are facing increased occurrences of intense hurricanes, floods, wildfires and droughts.
The issue for munis is two-fold. For starters, these sorts of natural disasters can destroy property and ruin the assets paid for with municipal bond issuance in the first place. But these events can have major financial impacts in other ways as well.

This includes reducing GDP and tax-bases used to pay back the bonds. New analysis by investment manager BlackRock suggests that just over 15% of the issuers in the S&P National Municipal Bonds index will suffer "climate-related losses of 0.5% to 1% of gross domestic product a year" over the next decade. Some states and cities are poised to fare even worse than the average. For example, in Miami, Florida, hurricanes and rising sea levels are estimated to clip 4.5% of the city's GDP per year over the study period. All in all, county data shows that more than 60% of the people in the U.S. face "risk of climate threat and insufficient readiness."

For the $3.8 trillion muni market, this is a huge issue. Muni's safety is driven by the underlying population's cash flows and the ability for states/cities to tax that cash to pay for bonds. With lower GDP rates due to climate change, muni bonds have the potential to get riskier.

This risk is now showing up in rising costs for municipal bond insurance.

In order to keep rates low, many municipal bond issuers will take out insurance policies that protect bond owners in the wake of a default. Basically, the insurance guarantees the repayment of the principal and all associated interest payments. Historically, this insurance has been cheap for bond issuers to acquire, making it worth their while to keep interest rates low. However, more and more insurance agencies are starting to add the effects of climate change risk into their models for underwriting. This has caused prices for muni bond insurance to steadily rise in recent years – adding anywhere from 0.2 to 0.5 basis points to the cost of a bond. However, analysts predict that bond insurance costs will be forced to rise further as insurance agencies grapple with climate losses and work new models into their underwriting.

Cities can't really forgo this insurance either. At the same time, more and more investors are starting to require this insurance to be added to bonds before investing. The latest Bloomberg data shows that $8.8 billion worth of new munis issued during the first quarter of this year had insurance. This was the most active first quarter for insured munis since the Great Recession.

The overall effect is that states and cities are forced to pay more for their needed capital, while their ability to pay for the bonds is constrained due to lower GDP/climate change damage.

Bigger Risks for a Sleepy Sector

For investors, climate change risks throw cold water on the supposedly risk-free status of munis. More and more investors seem to be getting that idea and demanding that more bonds be covered by insurance. All of this has had an added effect of increasing borrowing costs and making the finances of states/cities even more constrained.

None of it is good news for investors in the sector. In the end, investors need to re-think how they use muni bonds and understand that rising insurance costs for bonds is a direct reflection of the new risk reality in the sector.

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