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Additional ESG Disclosure Requirements Coming for Public Debt Issuers?

In a world where deadly heat waves, droughts, storms, wildfires and floods are becoming more widespread and more frequent every year, investors want to know about environmental, social and governance (ESG) risks when buying securities. To ensure transparency, the U.S. Securities and Exchange Commission (SEC) has proposed rules on ESG disclosure for corporate securities. And, where the private sector goes, public finance is usually close behind.

The investment community's push for guidance on ESG came from two fronts: the desire to invest in ventures with a focus on environmental, social and governing sustainability, and a need to understand risks that these factors pose to the overall security of any investment. In 2021, the SEC announced priorities addressing climate-related risks, and proposed rules in 2022 regarding the corporate disclosure of environmental, social and governing risks and the impact on publicly traded securities.

The Government Finance Officers Association (GFOA),), a membership organization of government finance professionals, which provides resources, education and best practices, followed suit by releasing voluntary ESG disclosure guidelines in 2021, and we recommend that officers responsible for municipal debt disclosures take note to avoid the potential litigation risks of non-disclosure. It will only be a matter of time before the SEC issues ESG disclosure rules for the municipal sector. Public agency officers should review what's happening on the corporate side now to be ahead of the game. See "The Evolving Word of ESG Disclosure," webinar presented by Best Best & Krieger here.

What environmental risks municipal issuers should disclose

Environmental risks have significant material impact on municipal securities. If a community is located in a fire-risk area and the property taxes secure bonds, casualty loss of a group of houses in a wildfire could reduce the community's ability to collect sufficient property taxes to pay that debt. Investors want to know that risk.

A discussion of risks can be complex, but public entities would be wise to take the time to assess them during the early stages of planning public issuances. Such a discussion may appease investors, reduce the likelihood of claims that such risks were undisclosed in the event of some unforeseen event and ensure success of the agency in its ongoing communications with investors.

Issuers should identify physical risks that could impact a debt-financed project. Are there risks of wildfire, tornados, flooding, wind damage or coastal erosion? Could natural disasters wipe out the project itself, or the tax base that services the debt?

Some questions to address are: Could higher temperatures, changing climate, or the increased frequency and intensity of natural disasters disrupt power generation or farming? Could climate-related changes, such as the rise of sea level, change the consumer or tax base that will service the debt? Could these changes impact prices for real estate in the area? Will current residents leave as a result of the climate related change? How might these risks impact business operations or services?

Additionally, a discussion of resolution might be needed. How will the agency mitigate climate-related risks? Is there technology investment needed to offset such risk? What would be the cost of researching and developing these offsets? Has the agency implemented prevention measures, such as wildfire cameras or detection systems?

Comprehensive disclosure could also involve discussions about greenhouse gas emissions. The SEC's proposed rules identify three scopes of emissions. For example, if you have a toy factory in your city, Scope 1 includes direct emissions out of the factory's smokestack; Scope 2 includes indirect emissions, such as for purchasing energy to run the plant; and Scope 3 includes downstream emissions, such as those from transporting the toys to retailers.

Finally, for environmental risks, the GFOA recommends including cautionary language similar to what issuers include on financial projections in official statements for bond issuances. This language should reflect the importance that no one knows what the actual impacts of climate change will be, and these disclosures are forward-looking projections based on facts available to date. The issuer cannot guarantee any results from mitigation measures or impacts as assumed.

Recommendations for disclosure on social and governance risks

The GFOA recommends disclosing information about demographics, income level and wealth disparity, housing availability and affordability, the availability and affordability of services, access to and quality of education, and other resources. Investors want to know about employment statistics, labor relations and challenges for public entities, and the long-term costs related to labor such as pension and other post-employment benefit liabilities.

For example, investors want to know about social risks that could impact service to general obligation bonds, such as a sudden decline in population. Or, if a school district issues debt, investors want to know if a drop in enrollment will impact the ability to service bonds for a new facility.

Governance is the ESG factor that is already widely discussed in most offering documents. Issuers should include a description of the entity's organizational structure and offer transparency about debt management policies and how financial policies are implemented. Investors want to know when a budget is adopted each year and when financial reports are issued. They also want to know about budget controls and how an entity generates revenue assumptions.

Issuers should also disclose any governance instability that poses risk. For example, continuity in administration is important. Investors want to know the composition and term of board or council membership, and they want to know if there have been departures in executive management or significant turnover in operating staff.

Naturally, issuers should always be transparent about any lawsuits, federal or state investigations or other actions against the agency.

Increased investor scrutiny of ESG factors will force governmental agencies to improve their own due diligence for bond-financed projects. Public officials have a variety of resources at their disposal, such as regional climate change impact studies, local developers, real estate appraisers and economists, who can help evaluate the risks. Analyzing risk will help municipal issuers better plan their future projects and manage their finances over time. Environmental, social and governance factors impact everyone, and before long, issuers will need to provide comprehensive disclosure regarding these risks.

Reuters

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