ESG AND THE MUNI DEALER COMMUNITY

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To quote from rock musician Sting, "the numbers lead the dance". Lately, the "numbers", or rather, the data, have been overwhelmingly supportive of the municipal market, thanks to the very aggressive fiscal stimulus package pushed through by the new Administration. In fact, save for a short period of unprecedented volatility between March and June of 2020, the tax-exempt asset class has displayed remarkable resiliency throughout the pandemic and may in fact come out of this health crisis in slightly better shape, with the exception of a couple of sectors (e.g. Higher Education and Senior Living). Even the State of Illinois got a minor upgrade out of it, despite having not solved a single one of its structural deficit issues!

Now that market dislocation and credit concerns have abated, as evidenced by historically tight credit spreads, one would expect the municipal market to finally follow in the footsteps of the rest of the financial markets and start focusing on the so-called "Environmental, Social and Governance" ("ESG") issues. Is ESG mainly a "buy side" issue? Aside from giving the clients (the buyers) what they want, how should the dealer community approach ESG concerns?

Confusion Reigns

It has been said the municipal asset class is the ultimate ESG play because public finance is by definition, designed for the pursuit of the common good. Hardly a day goes by that "ESG" is not mentioned in every municipal market webinar. Yet, there appears to be little consensus at this time about what ESG standards are and how they should apply to municipals. In truth, up until recently, ESG has reached much wider acceptance with global investors than with domestic investors. There is no dearth of ESG-related data but no one, to our knowledge, has offered an analytical model to tie all that data together. To date, most of the attempts to bring ESG to the municipal market have come from corporate sector vendors with limited appreciation for the complexities of our market. What can we make of this current state of affairs?

"Risk" vs "Impact" Components of ESG

For the sell side professional, the key, we believe, is to distinguish between the "Risk" aspect and the "Impact" aspect of ESG. The "Risk" aspect is what most people would traditionally view as a component of regular credit risk, something that investors and traders would want to mitigate or be protected against. The "Impact" aspect, on the other hand, is meant to reflect an investor's intent to use their investment dollars to encourage or promote a certain set of outcomes he or she perceives as socially desirable, such as the preservation of the environment, the reduction of racially-based economic disparity etc...

To illustrate, under the "Environmental" umbrella, one would find both "risk factors", such as the physical risk of climate change (forest fire, floods etc...) and carbon transition risk; and "impact factors" such as the promotion of environmentally friendly ("green") projects. Under the "Social" heading, one may find risk factors such as the risk of social unrest having a fiscal impact on a community, and impact factors such as socio-economic disparity. Similarly, the "Governance" area may include cybersecurity, clearly a risk factor, as well as the quality and composition of a health care system's board, features which are more impact-oriented.

Obligor Level Assessment vs Project Level Assessment

Another distinction we find useful is the difference between obligor-level ESG assessment and project-level assessment. An investor may choose to assess any State or local government unit as a holistic entity or choose to focus instead on the actual projects that such entity has undertaken. The current bond categories of "Green" and "Social" bonds are essentially project-level categorizations. When investors focus on the Use of Bond Proceeds, they are mainly concerned about the nature of the project, not about the bond issuer itself.

Focus on "Risk", Leave "Impact" to the Buy Side

The pricing of risk is what we do in the debt markets and ESG risk factors should be viewed in this context. ESG risk, particularly climate change, is most likely to have an impact on bond yields and quality spreads. At this time, the main hurdle standing in the way is the absence of a common standard for estimating the financial impact of such risk, in other words, an ESG risk scoring system similar to the traditional credit ratings. It would be hard for the market to price the risk (i.e. in terms basis points of yield) without some kind of common benchmark. As is the case with credit ratings, not everyone has to agree with such an ESG risk score, and market participants can always trade with or against the commonly accepted ESG scores.

For the sell side of the municipal market, the notion of ESG risk holds important implications regarding risk management and disclosure practices. If we're proven correct, and the market eventually finds a way to price ESG risk, no trader or capital committer can afford to be unaware of the ESG characteristics of the various bond issues they trade.

Furthermore, where there is risk, there is a need for proper disclosure. The SEC, under new Chairman Gensler, has already started to zero in on climate change disclosure for the corporate sector and it stands to reason that municipals will be among the asset classes next in line. Disclosure sections on climate change and cybersecurity have already started to show up in new issue official statements over the past couple of years, but there remains the need for disclosure standards in the secondary market.

Away from the ESG risk factors, Impact-type considerations are best left to the buy side since they are essentially a marketing tool for institutional investors looking to tap into a renewed sense of social responsibility from their investors. In fact, it's hard to envision our industry agreeing to a common standard on this subject, since impact is primarily in the eye of the beholder. Each investment company will come up with their special brand of ESG impact strategy to appeal to a specific audience. Separate account managers will probably ask their prospective clients to fill out an ESG questionnaire similar to the traditional Investment Policy questionnaire and use it to design a customized impact strategy for said clients.

As an underwriter of Green or Social Bonds, particularly of the self-designated variety, it would behoove you to impress upon your clients the importance of putting in place a rigorous process for monitoring ongoing compliance to the green or social framework they have committed to. The absence of such a disciplined process may lead to negative backlash from investors or worse, invite scrutiny from the SEC.

The issuers themselves should care about their own ESG profile, as it may eventually affect their cost of capital. The GFOA recently issued a best practices article on ESG Disclosure that encourages issuers to start with the E-Environmental factors, as it may be in their best interests to control their own ESG narrative:

"Issuers of governmental securities should be aware that there could be credit rating differentiation depending on their approach to addressing ESG factors. Without clear ESG information—either through a rating agency report or disclosures—potential buyers of municipal bonds are likely to conduct their own ESG analysis, which may not include all relevant information or context that a government can provide especially regarding steps taken to mitigate these risks. These factors should serve as motivation for governments issuing municipal bonds that are still questioning if ESG should be considered for their disclosure practices (...)"

Based on the above, those of you who are Municipal Advisors may wish to add ESG policy consulting to the range of services you can offer municipal issuers!

The Regulators Cometh

In summary, in contrast to the equities and corporate debt markets, the municipal market is still in the early innings when it comes to a widely accepted ESG framework. Until some basic market consensus about resiliency standards is achieved, we believe the broker-dealer community would be best-served to focus primarily on the key "risk" aspects of ESG, primarily climate change/transition risk and cybersecurity risk, and what they imply in terms of disclosure and risk management practices. We do believe it's only a matter of time before the regulators come calling.