

ESG Considerations for Governmental Issuers

Understanding ESG opportunities and risk factors
and why governments should make them a priority



Introduction

ESG (environmental, social, and governance) refers to three key types of factors that can impact a government's credit profile. In general, ESG factors represent areas believed to affect the long-term sustainability of a community, such as a community's exposure to climate risk ("E"), long-term demographic changes ("S"), or management of pension liabilities, among other governance issues ("G"). An increasing percentage of investors are considering ESG factors when evaluating, selecting, and monitoring their municipal bond investments. Many governmental issuers are also focused on addressing the significant ESG issues affecting their communities (e.g., climate change, pollution, cybersecurity, fraud, etc.) and how these ESG risks, as well as strategies and plans to mitigate them, are communicated to the municipal bond market and the public.

The majority of ESG factors are not new to issuers or investors; many ESG factors coincide with traditional credit factors historically looked at by both investors and credit rating agencies. However, current challenges, such as the climate crisis and concerns about population declines, particularly in rural areas, and the uptick in frequency and sophistication of cyber attacks have increased the focus on social issues, environmental risks and governance planning. Additionally, more information is now available, making it easier for investors to incorporate ESG factors into investment decisions.

ESG is being discussed and explored across the public finance industry. This resource is intended to help GFOA members understand the importance of ESG and how it relates to their communities.

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What is ESG?

ESG factors refer to specific areas that present risks or opportunities that could affect the credit profile of a government issuer and long-term sustainability of an investment. An ESG *risk* is identified as such because it could pose a risk to the government issuer's ability or willingness to repay its debt. Examples of ESG risks can be found in Figure 1.

An ESG *opportunity* is a little more subtle than a risk. It refers to an ESG-related credit strength. Examples

could include having an abundant water supply or affordable housing.

The term “ESG” is also sometimes used to discuss socially responsible investing, values-based investing, or impact investing, all areas of investment that are concerned with how bond proceeds are being used and the potential outcomes of that use. For the purposes of this paper, the term “ESG” will be used in discussion of credit risks/opportunities, and “socially responsible investing” to discuss use of proceeds analysis.

Figure 1 Examples of ESG Risk Factors



Environmental Factors

- Extreme weather, flooding, sea level rise
- Climate change affecting agriculture, infrastructure, and water supply
- Impact of carbon emission regs
- Violations & consent decrees
- Supply chain disruption



Social Factors

- Demographic changes & population trends affecting demand for services
- Income levels, inequality
- Dependent populations
- Affordability of government services
- Tax structure, taxing ability
- Labor unrest



Governance Factors

- Federal/state framework
- Management & policy framework
- Decision making transparency
- Headline risk
- Organizational structure
- Risk culture & risk mitigation
- Deferred maintenance
- Pension & OPEB



A note on climate risk

Climate risk has begun to receive significant attention. The increase in the number of wildfires and hurricanes in recent years have raised public awareness about climate change. The Yale Center for Climate Change Communication conducts a semi-annual survey of Americans on global warming and found that in December 2018, 59% were alarmed or concerned about global warming, up from 42% in December 2013.¹

Investors are typically looking at two main categories of climate risk: physical risks (which could include exposure to wildfires, sea level rise, flooding, water stress, or heat stress) and transition risks, which seeks to measure exposure to the effects of the transition off fossil fuels. Transition risks could include significant concentration of employment or the tax base in the fossil fuel industry, or for an electric utility, significant reliance on fossil fuel burning generators.

In general, investors and the rating agencies are not just looking to see if these risks are present, but also what plans a government issuer has to manage these risks, which could include creation and enactment of a climate adaptation plan, as well as allocation of resources available to offset the risks.



Investor Considerations

There are more investors today considering ESG factors when making their investment decisions than there were just a few years ago. Many in the investment community believe this trend will only continue. The motivations behind those decisions can be based on ESG risk assessment or impact/social investing priorities (what impact does the financing have on the community?).

ESG Risk Analysis

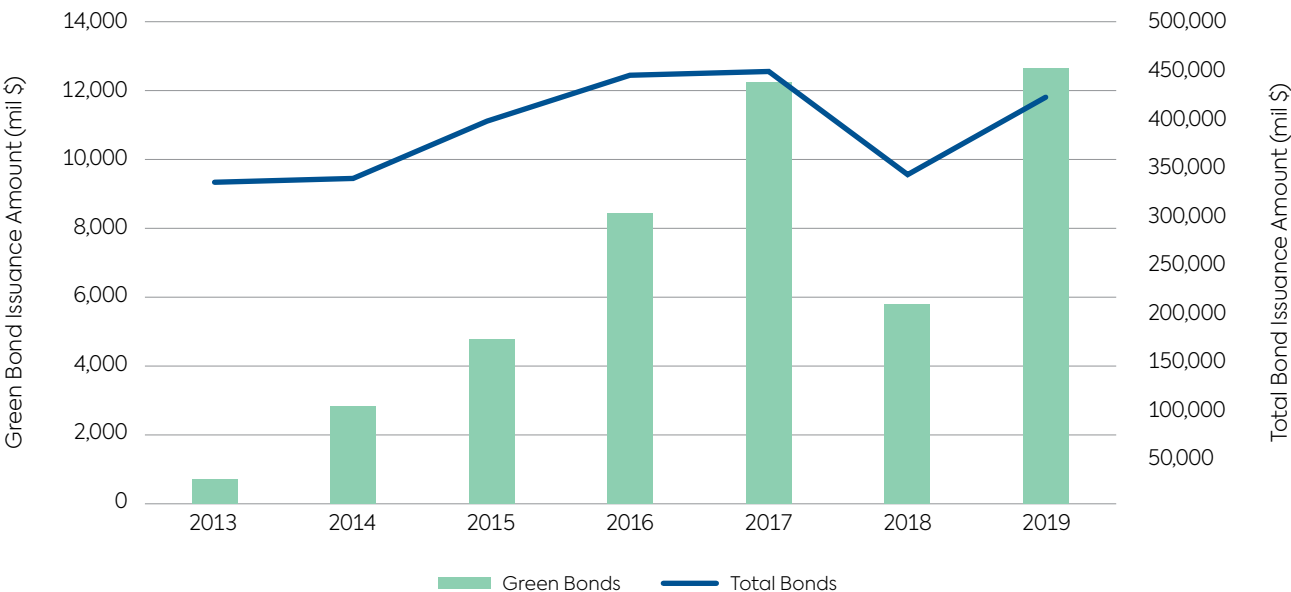
With regard to ESG risk assessment, many investors believe they will be able to sustain better returns over the long term and/or avoid credits experiencing distress by investing in entities that have fewer ESG risks or are actively managing those risks, as well as those who utilize good governance policies. These investors expect that with good ESG practices at the core of an issuer’s operations, they will be less likely to experience a decline in credit quality stemming from disruptors such as climate change, income inequality or the pressure from underfunding pensions. Issuers with good governance practices and transparent, proactive policies also provide investors with comfort that the organization can adjust to a changing world.

Socially Responsible Investing

Some investors are concerned about the environmental and social impacts of their investments. These investors are typically looking at the use of bond proceeds and are gauging the potential impact of an investment based on not just the issuer itself and its ESG practices, but what types of projects the bond is funding. These investors might be searching for particular types of projects, such as renewable energy or K-12 education, to put in their portfolios (a “positive” screen) or could just be trying to eliminate projects seen as harmful (a “negative” screen).

The good news is that many cost-saving government initiatives related to long-term planning could be considered by investors as ESG projects. Some examples of ESG-related capital spending include switching to LED lighting in government buildings; solar powered street lights; affordable housing initiatives; community support centers, and even the creation of retention ponds and green space to reduce combined sewer overflows. Regardless of the ESG-focus of the investors, it can be helpful to all investors if issuers provide transparency about the expected impact of the projects being financed, if the data is available.

Figure 2 Historical Issuance of Green Bonds by Amount²



Green bonds are one way to present this type of information to investors, though issuers can also include the information in their offering documents without getting a specific certification. Green bonds are regular municipal bonds that fund projects deemed as having environmental benefits. In general, Green Bonds can be designated as such if they follow the Green Bond Principles, a widely-agreed upon set of standards developed by investors through the International Capital Market Association.³ A number of certification organizations now exist that can officially classify bonds as “Green Bonds,” or “Climate Bonds,” or other categorizations, if issuers choose to seek out such certifications. Annual green bond issuance (across all assets classes) increased 120% in 2018,⁴ exemplifying the increasing market interest in these types of projects.



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Figure 3 Historical Issuance of Green Bonds by Issuer⁵

Rank	Issuer	Par Amount (US\$ mil)
1	Metropolitan Transport Authority (MTA)	6,875.7
2	NYC Housing Development Corporation	6,221.3
3	San Francisco City/County Public Utilities Commission	2,068.5
4	NYS Housing Finance–Mortgage Agency	1,882.1
5	Indiana Finance Authority	1,859.6
6	California Infrastructure & Economic Development Bank	1,666.5
7	Massachusetts Water Resources Authority	1,629.5
8	Massachusetts	1,369.1
9	Central Puget Sound Regional Transit Authority	1,342.8
10	San Francisco Bay Area Rapid Transit District	1,183.9

Case Study: Metropolitan Transit Authority (MTA), New York

MTA is leading the way in the issuer community for accessing capital in the municipal bond market to address ESG risks. The transit agency issued over \$6.8 billion in green bonds through the end of 2019. For example, MTA has set an ambitious goal to transition to a zero-emissions bus fleet by 2040. Its fleet already includes more than 3,300 clean diesel buses, 1,683 hybrid-electric buses, 749 compressed natural gas buses, and 10 all-electric buses. Other sustainability initiatives for MTA include the construction of facilities that meet LEED standards and leasing millions of square feet of industrial roof space to companies interested in generating solar power.⁶



Credit Rating Agency Considerations

Similar to investors, credit rating agencies have long incorporated many of these ESG-type risks in their assessments, so in many ways talking about ‘ESG’ just puts a new frame on an existing picture. From a rating agency perspective, there is can be a correlation between higher credit quality and the inclusion of ESG factors in a government’s goals and practices. An issuer that is transparent in implementing and adhering to policies which reduce or improve environmental or social pressures may also be assessed higher on the management component of their rating.

In order to achieve the highest level of transparency, it is important for issuers to understand what credit rating analysts need to evaluate and why. How issuers respond to a broad range of ESG-related questions from credit rating agencies is critical to making sure issuers demonstrate appropriate planning and preparedness.

Even though many core ESG factors have been a long-standing component of credit analysis, the rating agencies have responded to the changing needs of today’s investors by becoming more transparent in their published works about how they integrate ESG factors into their municipal credit ratings. For example, the rating agencies have begun to add sections to their rating reports discussing the environmental risks of a governmental issuer, in particular in areas susceptible to increased flooding or wildfires, and all four agencies have publications describing what they are looking for in assessing ESG risks. Issuers should expect conversations surrounding ESG factors will be a consistent focus with ratings analysts going forward. There is no one-size fits all for questions or responses, as the relevance of ESG factors to a particular issuer can vary substantially depending on each issuer’s geography, topography, existing infrastructure, etc. As the ESG concept continues to evolve, the landscape for



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how ESG factors are evaluated will likely mature significantly from where it stands today and we can expect ongoing information from the rating agencies on the topic of ESG and ratings.

Issuer Disclosure Considerations

With the increased focus from both investors and credit ratings agencies, issuers will likely continue to see more requests for better disclosure related to ESG factors. It is important to understand that an investor or credit rating agency's focus on assessing ESG can correlate closely to how well issuers are managing their operations via a responsible, transparent, and adaptable governance structure, particularly as it relates to the pressures that government faces. However, additional efforts or policies aligned with reducing harm or making improvements to environmental and social issues will likely be of interest to investors concerned about ESG risks. The key for municipal issuers is to determine which ESG factors are material to their own credit profile and relevant to investors. From there, issuers should tailor their disclosure around those elements.

Since the specific ESG risk factors that materially impact credit quality will vary significantly by sector and even for individual issuers within each sector, it is difficult, if not impossible, to prescribe one guideline for ESG disclosure that fits the needs of all municipal issuers.

However, generally speaking, good disclosure of ESG risk factors contain the following elements:

1. **vulnerability assessment**, or recognition of ESG related risks,
2. **plans/preparedness** for mitigating such risks, and
3. **progress updates**, including impacts of recent ESG elements/events and how they shape future response.

To comply with federal securities laws, issuers should already be considering and disclosing material risks to investors as part of their primary market disclosure practices and ESG disclosure can be an expansion of that practice.

The more clear issuers can be within their offering statement on the use of bond proceeds and benefits or expected impact of projects on the community, the more likely that these types of bonds will be sought out by impact investors therefore increasing demand for your bonds. However, issuers should use caution to not overstate such benefits without the facts to support those claims. Additionally, the question remains of whether or not certification programs, such as Green Bond assessments, yield savings to issuers through lower interest rates compared to the costs associated with obtaining and maintaining such certifications. Such programs can impose additional burdens on issuers in terms of time and money and those costs should be carefully considered, especially when tangible benefits in terms of reduced interest rates on bonds is unclear.



Conclusion

Both investors and rating analysts have been increasingly utilizing outside resources to assess the materiality of ESG risks for municipal issuers. Issuers play an important role in that overall assessment by providing specifics about their ESG challenges and action plans. This provides issuers the opportunity to tell the story of what they are facing on the ground, a point of view that is valuable to both investors and rating analysts.

Municipal bonds serve as a vehicle for impact investments and many investors want more information on the expected impact their municipal investments can have. This is where increased ESG or use of proceeds disclosure can help broaden the pool of potential investors. Additionally, since bond ratings and investor demand have a significant impact on the pricing of municipal bonds, it is generally in the issuer's best interest to provide this disclosure directly to their investing community through primary offering documents and secondary market disclosure. The increased focus and awareness from investors could also have the positive consequence of encouraging more issuers to increase their on-going efforts in identifying and mitigating ESG risks.

Overall, issuers should be aware that there could be credit rating differentiation depending on their approach to addressing ESG factors. From an investor perspective, without clear ESG information—either through a rating agency report or other disclosure—potential buyers may be conducting their own ESG analysis, which may not include the whole story as presented by an issuer. These factors should motivate municipal issuers who are still wondering if ESG should be a consideration for their disclosure practices, to invest the time needed to explore the subject and consider its application.

¹ Yale Center for Climate Change Communication. "Americans are Increasingly 'Alarmed' About Global Warming." February 12, 2019. <https://climatecommunication.yale.edu/publications/americans-are-increasingly-alarmed-about-global-warming/>.

² GFOA analysis of Thomson Reuters data available as of 12/31/2019

³ *Green Bond Principles*. International Capital Market Association. <https://www.icmagroup.org/green-social-and-sustainability-bonds/green-bond-principles-gbp/>.

⁴ GFOA analysis of Thomson Reuters data available as of 12/31/2019

⁵ Ibid

⁶ More information on MTA's Capital Program can be found at <https://new.mta.info/document/10401>.

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