PERSPECTIVE

Will the Real Municipal ESG Please Stand Up?

BY JUSTIN MARLOWE

No three letters have stoked as much recent ire as "ESG." Fortunately, recent trends suggest a "new ESG" could be a powerful financial opportunity for states and localities.

ESG stands for "environmental, social, and governance investment principles." At its core, it's the idea that investors can make money without harming people or the planet. That means not investing in industries like fossil fuel production or tobacco. It also means avoiding companies with questionable records on human rights, employee relations, and shareholder protections, among many other factors.

It's also nothing new. Investment philosophies grounded in religious principles have been around for centuries. As early as the 1970s, big asset managers offered mutual funds that allowed investors to steer clear of businesses connected to apartheid-era South Africa. These early efforts sparked investors' collective imaginations, and today there are more than $20 trillion in assets across the globe managed according to ESG principles. In January of 2023, the United Nations Principles of Responsible Investment's Sub-Sovereign Debt Advisory Committee—the de facto standard-setter for ESG investing—issued a report titled "The Thematic ESG Approach in US Municipal Bonds." This report signaled the ESG had arrived in municipal finance.

But more recently and more locally, municipal ESG has been fraught territory. Many state and local elected officials believe ESG is an unfair attack on the fossil fuels industry, an industry that, ironically, includes some of the most prolific investors in renewable energy.

A related concern is that a state or local government cannot fulfill its fiduciary duty to taxpayers, nor can an investment manager fulfill their fiduciary duty to their client, by restricting the range of investment options. Former Louisiana Treasurer John Schroder, who in October 2022 famously banished BlackRock (which currently manages more than $10 trillion in assets) from managing public funds in his state, said at that time that BlackRock's "focus on political or social goals or placing those goals above the duty to enhance investors' returns is unacceptable under Louisiana law." For these and other reasons, 20 states now prohibit ESG principles in public pension fund allocations and other public investments. In response, three states have passed "pro-ESG" measures including, "anti-anti ESG" or "ban the ban" legislation. And the number of states in both camps is growing.

This politicization is unfortunate for several reasons, but mostly because it's confounded what ESG can and should mean to state and local governments. ESG is really an amalgamation of three loosely related investment philosophies. One is social impact investing. Here, the recipient of that investment agrees to make progress toward a set of environmental and/or social outcomes. In municipal finance, the City of Chicago's award-winning "Social Bond" is a good recent example. In this transaction, Chicago borrowed $160 million to finance new investments in affordable housing, blighted property restoration, and related projects. The terms of the deal require Chicago to measure and routinely report if and how those investments are reducing homelessness, improving public safety, growing small businesses in underserved neighborhoods, and so forth. Dozens of other cities, housing finance authorities, community colleges, and other borrowers have done similar deals designed to appeal to impact investors.

A second and broader notion is "do well AND do good." Here, investors gravitate toward projects that are broadly in line with goals like reducing carbon emissions or closing educational achievement gaps. States and localities have developed new products to meet that demand. According to Standard & Poor's, in 2022, municipal borrowers issued $40.9 billion of labeled "green, social, and sustainability" bonds, an amount roughly equal to ten percent of all municipal bond issuance. These bonds don't obligate the borrower to specific measurable outcomes, but they do appeal to a growing body of municipal ESG investors around the globe.

A third and far less appreciated approach to ESG is "de-risking." Critics and defenders alike can agree that ESG factors matter because they are "pre-financial." For instance, if a company's supply chain depends on minerals

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extracted from a country run by a brutal dictatorship, that company is exposed to major cost increases if social unrest in that country forces it to find that mineral elsewhere. Smart investors will ask that company about its plans to mitigate that risk. If it doesn't have a plan, investors will put their money elsewhere.

There's much work to be done in de-risking state and local infrastructure in accord with ESG principles. The United Nations Sustainable Development Goals—a key framework for ESG investing—has identified 169 measurable indicators of progress toward decarbonization and sustainable development. Sustainability experts have shown that 120 of those indicators are influenced directly or indirectly by basic municipal infrastructure. This is especially apparent for carbon emissions, given that energy, transportation systems, public building, and water infrastructure are responsible for more than 60 percent of global greenhouse gas emissions. That's why it's no surprise the federal Infrastructure Investment and Jobs Act passed in 2021 included more than $200 billion to modernize the electric grid, secure and expand transit systems, and repair water distribution systems, among other investments in basic state and local infrastructure. Who knew that building and maintaining good, old-fashioned public infrastructure is, in fact, ESG investing?

Investors have observed the backlash against ESG and the money to be made de-risking public infrastructure, and they responded predictably. Recent figures show that in 2023, they pulled $13 billion out of ESG funds. But during that same time, they poured $75 billion into investment funds focused on renewable energy and public infrastructure to support decarbonization. In fact, across the globe investment in the transition to clean energy was $1.8 trillion in 2023, up 17 percent from 2022, according to figures from Bloomberg. Even BlackRock recently announced a plan to put $550 million in a major carbon capture facility in the State of Texas, a move that drew praise from Texas politicians who'd excoriated the firm just a few months earlier. It seems that investor demand for opportunities to upgrade and modernize public infrastructure will only grow.

The culture wars over ESG will likely rage on. But as they do, state and local issuers should take full advantage of the terrific opportunity, just beyond the ESG acrimony, to continue investing in basic public infrastructure.

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