Poor data renders muni ESG rudderless

By [Matthew Posner] [James McIntyre]September 20, 2023, 9:21 a.m. EDT8 Min Read

The public finance industry has put the cart before the horse when it comes to environmental, social and governance (ESG) and impact investment practices. Labels, proprietary investor modeling and data platforms behind paywalls obfuscate the real problem: the data and its contextualization for the public (and investors) to understand the intent behind municipal securities is not well understood and is not being properly disseminated.

Public finance and public trust must go hand-in-hand and that is where ESG and impact investing can play a role moving forward — it's the data, not the label.

The rise of ESG and impact investments has captured the attention of governments, investors and policymakers. However, we must question the true efficacy of efforts to label or designate ESG for municipal securities where they often serve as distractions from the underlying information that governments are disclosing.

For example, in 2019 the New York State Housing Finance Agency set to redesign its housing finance program by designating its debt offering as sustainability Bonds, it reformatted its offering statement around the International Capital Market Association's Sustainable Bond Guidelines, building upon their Climate Bond Initiative designation, and layering in a linkage to the United Nations' Sustainable Development Goals, a first in the United States muni market. And while that was important, more important was the restructuring of their data sets, creating new tables, consolidating information from throughout the document, into a digestible and cohesive format of presenting data on the projects being financed

In doing a listening tour with investors, the HFA found that investors were not just looking for ESG factors, they were looking for data points to guide their investing. Among other data points, telling investors the project address, highlighting any environmental risks, including flood plain and the state's review and mitigation process, the population the housing was serving, and the various subsidy sources supporting the debt or subsidizing the upfront cost of the building. All those factors are de-risking factors for their investors. They help support not just the narrative of the issuance, but the credit.

The result, in a little over a year after the launch of their new program, New York State HFA added over 40 new institutional investors. It was never about ESG, it is always about data, hearing investors on what they need, and not failing to disclose material factors about the financing that either bolster or hinder the credit.

But bringing forward relevant municipal data has always been challenging, nearly as challenging as deciphering credit worthiness in 300+ pages legalese-laden offering statements. In the modern era of public finance, the industry has relied on these documents to move risk from the issuer to the investor's balance sheets (and into the homes of Americans) that offer little in terms of understanding the true nature of a government's action and instead on long-standing legal traditions. Even issuers who have wanted to change face reluctance from market participants that don't see the materiality in additional disclosure or shy away from the value of concise, standard presentation, which is more digestible, saves time and money in execution, and is easier to invest in — as companies like Neighborly proved was possible in their limited public, but direct-to-consumer offerings.

ESG and impact data are absolutely relevant to the asset class. Issuers would benefit from offering more project-level data and contextualized macro data to offer a clearer picture of their plans for their communities.

Municipal finance is the definition of embedded placed-based risk, and yet there is no clear path to this disclosure in the market.

The oft-dangled international or impact investor is much more likely to emerge if a security's intent is supported by clear, independent data — not an unsubstantiated designation.

An open dialogue about data and its use in the industry as a whole could help it better fit into the national conversation about climate volatility, social change and government accountability — all would help manage the politics that have emerged about ESG. Government officers will benefit from evidence-based, decision making tools for their debt programs but also in a larger budgetary context and communicating with their residents — all areas that should be distinguished from the materiality discussion.

ESG, when approached correctly, should be about analyzing the data that exposes a municipality's reliance on short-term energy solutions or its commitment to fostering thriving businesses and investing in traditionally economically disadvantaged parts of their communities. Or their budget's exposure to extreme weather events. The crux of the matter lies in the effect that these decisions, whether labeled as ESG or not, have on a municipality's credit and credibility. The decisions, irrespective of their ESG alignment, are already reflected on the balance sheets of our communities.

We must recognize that ESG labels can unintentionally open the door to greenwashing, where entities make exaggerated claims about their environmental or social performance to attract investors. In the municipal finance market, this could result in cities or states claiming ESG-friendliness without implementing meaningful changes to their policies or practices. Such greenwashing not only misleads investors but also undermines the credibility of the entire ESG movement.

To address these concerns, we must prioritize transparency in municipal finance. It would behoove municipal governments to disclose comprehensive information about their efficacy of financial decisions and ensure easy accessibility for investors and the public. Additionally, there should be increased oversight of ESG labeling firms to ensure the accuracy and integrity of their ratings.

The movement in the last decade to expand the asset class beyond a tax-strategy and into the world of impact investing along with understanding corollary, non-financial risk and return of municipal securities should continue, but there is considerable work to be done before state and local governments can truly benefit from these efforts.

Internal and third-party labels have offered incremental steps toward moving the public finance industry forward with ESG concepts but offer little in terms of evidence-based claims, few tangible pricing differentiation and really only shine light on the fact that public finance data science is in its infancy.

The explosion of big data has made its way to municipal bonds and it is up to the industry to ensure it is not hidden behind paywalls so the true intentionality behind municipal securities transactions are fully understood and openly debated. Useful to the municipal bond industry and in line with ESG concepts would be to build an open-sourced data dictionary that would allow the public to quantify the impact bonds have on communities. Making it available to the public in a user-friendly format would open the dialogue about big data and public finance. The biggest concern that issuers should have about the proliferation of technology and data geared toward the municipal market is that opinions are being formed on credits that are created in a vacuum and live behind a paywall. And this momentum should carry into the outcomes of the Financial Data Transparency Act.

There are a litany of issues that have prevented a larger dialogue from occurring in regard to what ESG could really mean for the industry. Principal among them is the very real concern from bond issuers that applying new data-sets to bond offerings slips into the discussion of what is material and what needs to be disclosed. The middle ground here is providing *relevant* data-sets that give issuers the *option* to connect their municipal bond transactions where they see fit. The hard stance that disclosing ESG means repealing the Tower Amendment is short-sighted. Materiality does not have to be part of the discussion and a body of thought from the legal community on where data can be applied as supplemental impact information and directly credit related from a disclosure standpoint, should occur.

The associations that represent market participants, whether they be dealers, advisors, lawyers, investors or issuers, should see the long-term advantage to thinking about what this future means instead of protecting historical practices and precedents, including under disclosure of municipal placed-based risk.

Finally, ESG may not be a term well suited for U.S. public finance. The way in which taxonomies were designed for ESG fit much better for the for-profit world and the international development space. Instead, support for *government efficacy* is something that should be strived for. In academic circles of political science, efficacy is essentially a citizen's trust in government and their ability to influence the government's actions. Government financial efficacy is the ability to measure a desired result or intent of a government's financial decisions. This is a perfect fit for municipal bonds — can we measure that a bond is actually doing what the government is telling us is its intention?

The storms and fires are coming harder and faster, temperatures are rising and water availability is diminishing — perhaps some munis want to keep that disclosure to themselves. Others, namely investors, want to see it easily in print.

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