Community Finance Brief

Overcoming Obstacles to Impact: Disclosure, Part 1

CSG

MATT POSNER | COURT STREET GROUP LLC

The impact investment space has struggled to wrap its arms around the municipal bond market in the United States. From the impact vantage point, this is a marketplace that makes a compelling argument to be considered as an asset class that could fit into various impact-related parameters: by law, the bonds must serve a public purpose, the sectors of issuance (including water, education, energy, housing and healthcare) lend themselves nicely to the United Nations Sustainable Development Goals (and other international impact criterion) and the governments that issue them directly impact all people living within their jurisdictions with a legal and ethical responsibility to provide goods and services to those people.

Despite the theoretical fit in many regards, the industry has struggled to meaningfully engage the worldwide community of impact investors. There are a growing number of impact investors that see an opportunity to address social issues like racial equity or mitigate risk associated with climate change. Yet, the billions of green, social and sustainable municipal bonds that have been issued to date represent just under 10% of the entire market since 2021, according to S&P Global Markets. **That number can and should be larger**.

This series will dig deeper into the obstacles and challenges that in some cases have been in place for decades and others that have arisen as a result of the strategies that impact investors would like to employ. Further, this series will offer solutions or suggestions on ways to move forward.

THIS ISN'T YOUR ORDINARY BOND MARKET

Disclosure is the cornerstone of impact investing. The decision of a publicly-traded company, a corporation or a

Quick Takes

In 2022, just over $40 billion municipal bonds were issued that were labeled Sustainable, Social or Green
– S&P Global Markets

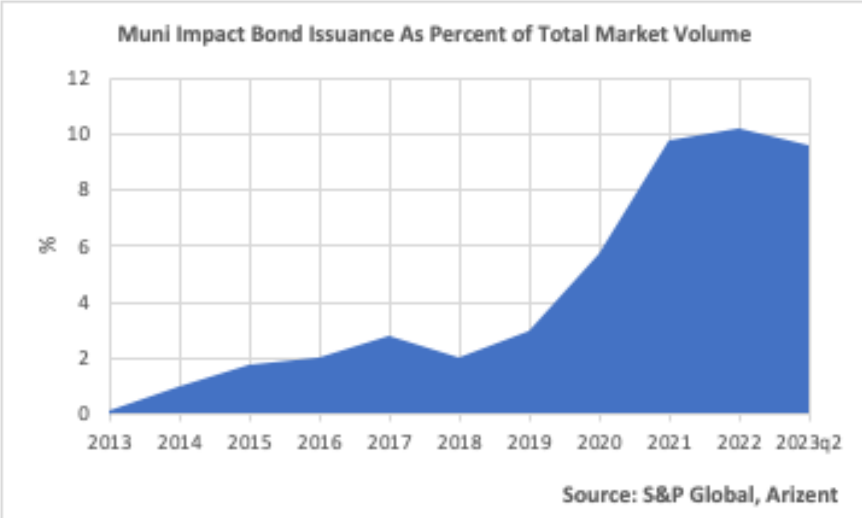
Of the $158.4 billion of municipal bonds issued in the first six months of 2023, $15.3 billion were green, social, sustainable or sustainable-linked bonds; 9.6% of all issuance
– S&P Global Markets, Arizent

Impact-oriented issuance in the muni market has leveled off in part due to the politicization of ESG

Affordable housing muni bonds represent nearly half of all green or social bonds
-Climate Bond Initiative

70% of muni impact-oriented labeled bonds have no independent verifier
-Bloomberg

Government's prefer to self-identify green or social attributes of their bond issuance, reflecting a lack of any meaningful organization or understanding of social and/or environmental attributes to municipal bonds



government to explain to potential investors how its actions have an impact on the world outside of profits and loss is a requirement of any impact framework. In the U.S. public finance space, states and local governments disclose, prior to sale and generally in continuing fashion (more on this in part 2), information that is material to the terms of the bond and on the financial state of the obligated party issuing the bonds.

While obtaining information about a company's future plans or a country's development policy can have broad impacts on the environment and the social fabric of a community, there is no other marketplace in the world like that of the U.S. municipal bond market and it deserves to be nuanced.

Historically, municipal disclosure has been a point of contention between governments, their advocates, regulatory bodies and the various market participants that engage the market place. This is the result of no standardization along what information is submitted, debate over what is material to the financial health of an issuing body and that there is little regulatory enforcement over municipal bond disclosure itself in the United States. Add to that, the current method of uploading PDFs to a central repository that, to-date, is not machine readable, adds a technology component to the process in which the aggregating of information is very challenging.

With the rise of impact investors, questions around disclosure have increased with a emphasis on what is considered material to the creditworthiness of a municipal bond but more importantly, can the field of municipal bond disclosure move beyond immediate financial metrics of stability for a government

"It is difficult to overstate the importance of the municipal securities market," wrote **Luis A Aguilar,** Commissioner of the U.S. Securities and Exchange Commission in a 2015 public testimony. "There is no other market that so profoundly influences the quality of our daily lives… despite its size and importance, the municipal securities market has been subjected to a far lesser degree of regulation and transparency than other segments of the U.S. capital markets. In fact, investors in municipal security are afforded 'second-class treatment' under current law in many ways. This has allowed market participate to cling to outdated notions about how the municipal securities market should operate. The result is a market that, in the view of many, is excessively opaque, illiquid and decentralized. "

and into a more holistic review of relevant, non-financial corollary issues such as climate, equity and social drivers that are affected by the programs these bonds fund.

Many of these obstacles to better information about municipal bonds remain outstanding. It offers several paradoxes for investors that from an outside perspective leave some to question the value of the marketplace's existence itself. In response to that, many would ask where else in the world do small communities like those that issue bonds in the municipal market not only raise funds, but do so at compelling interest rates? What other markets have default rates as low as those in the municipal market? (**see table, below**), To the disclosure problem in general the industry responds: "progress, not perfection."

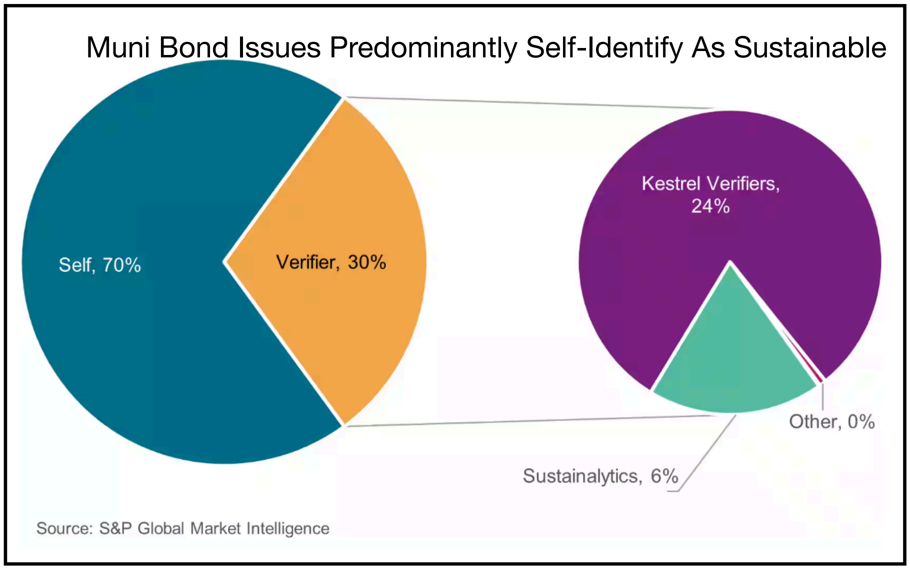
"The storms and fires are coming harder and faster, temperatures are rising and water availability is diminishing – perhaps some munis want to keep that disclosure to themselves," writes **James McIntyre**, chief strategy officer of Inclusive Prosperity Capital. "Others, namely investors, want to see it easily in print."

THOMAS JEFFERSON, 16TH AMENDMENT & MUNICIPAL BONDS

The market's origins are rooted in the formation of the nation itself and reflects the early concern that the former colonies required a certain amount of sovereignty from the new federal entity overseeing them. As such, the municipal market allows for financial freedom that any sub-sovereign entity within the borders of the nation (and it's territories) that can not only access a marketplace to raise funds but also earn an exemption from income taxes if the project serves a public purpose (this came later with the 16th Amendment to the U.S. Constitution). It is a radical idea that through the growth of the nation played a major role in developing its early urban centers, its western expansion and supporting rural communities' while connecting communities to the financial decisions of their governments. That it would eventually be the primary financing mechanism for state and local infrastructure in this day and age is not ideal as

Moody's Rating	10-Yr Muni Default Rate	10-Year Corp. Default Rate
Aaa	0	0.35
Aa	0.02	0.77
A	0.1	2.04
Baa	1.09	3.61
Investment Grade	0.1	2.24
Non-Investment Grade	7.11	29.66

Source: Moody's, July 2021



In essence, municipal bond disclosure is about transparency of public funds. Is a government doing what it says it is doing? Is a policy plan reflected in the way dollars are spent? Disclosure in the municipal bond market is about accountability and the impact of these projects is a function of that effort. There is already $4 trillion worth of risk on the table, how much does the public really know about it?

-A "Waiting for Godot" moment between CSG & Google Bard

modern capitalism rewards efficiency, standards and products in bulk with lower interest rates.

The disclosure of information around current day municipal bond transactions becomes even more important as one considers the decentralized nature of the marketplace compared to other nations around the world. Because there is no centralized authority wherein decisions are made and information is disseminated as is the case in other nations, the value of state and local disclosure becomes more important. This also underscores of lack of consistency in planning at an intra-governmental level: the federal government, the states and all the sub-state governmental units have the independence to make their own financial decisions through the municipal market, which leaves uniform policies to be desired.

GOVERNMENT TRANSPARENCY IN INTENTIONS

Rating agencies review issues such as financial strength, economic factors, legal and regulatory frameworks, debt structure and repayment plans and governance, among others, and assign a rating on a municipal bond issue that is directly correlated to the interest rate when a bond is issued. This framework is important in credit analysis yet adheres to a financial assessment system that at times can miss the holistic: this is is all about the public purse (**see quote, right**).

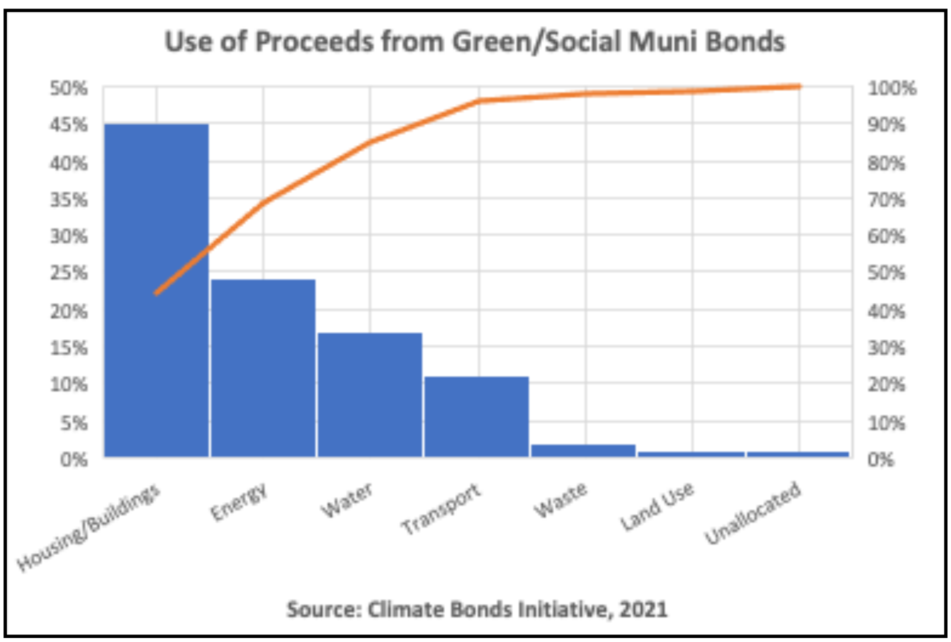
When considering how to spend communities' collective funds, **CSG** believes it goes hand-in-hand to review the impact of programs on where and the way people live their lives. Yet, little has been done in regards to consistency in connecting environmental and social factors when it comes to municipal bond disclosure. Instead, the industry has adopted a haphazard series of labels and self-identifying programs that governments or their advocates can claim some sort of achievement that goes beyond the ability to pay back the debt. There has been few attempts to come together under a set of understandings, which is not surprising given the decentralized nature of the market itself just described.

As such, it could very well be a legal battle that forces change. The biggest debate in the materiality/ESG thread at this point in time is whether or not climate change is a material factor for a government to disclose when it issues a bond. While to some there is an obvious answer to this question, in the public finance market there is no clear answer to this and leaving it unanswered could potentially be taken up by the courts as an investor advocate is likely to sue after a local government failed to mention it may be impacted by rising seawaters, or something of the like.

Until then, the market is likely left treading water at 10% of the market labeled as one thing or another and we do not expect the larger impact community to adopt this sub-sovereign market for what it is.

DISCLOSURE CAN LEAD TO A BETTER FUTURE

Today, this marketplace represents $4 trillion outstanding in investments in America's infrastructure and serves as a key avenue for investors to support community development and sustainability. Paring this massive footprint on infrastructure finance with the dislocated process of information around these projects, and the governments that finance them is the crux of the problem at hand. Given the political history of this marketplace, it is nearly impossible to legislate any changes to how it operates (although use of proceeds for green/ social muni bonds do pair nicely with the Inflation Reduction Act, **see figure, below**). As such, the market has continued to operate as is but there are some that view the rise of impact investing as a potential market solution to the issues revolving around disclosure.



If the marketplace were to begin to disclose more information related to impact metrics, and begin to take into account broader socio-economic and environmental elements that are relevant to these projects, more investors would invest in these bonds and the cost of capital for taxpayers would be reduced. Additionally, in theory, a better understanding of these issues would also make for better governmental decisions.

As governmental financial efficacy considerations gain prominence in investment decision-making, transparent and comprehensive disclosure practices become increasingly important. Providing transparency about a municipality's financial health through its bond efforts, current disclosure practices offer key information about state and local governments that cannot be found elsewhere.

Areas that need to be addressed are summarized in the four points below:

1. Non-Financial Risk Assessment: Comprehensive disclosure allows investors to evaluate a municipality's commitment to environmental sustainability, social equity, and strong governance practices. It enables the assessment of efficacy risks, such as exposure to climate change impacts, social inclusivity, labor practices, community engagement, and ethical governance.
2. Project-Specific Impact Assessment: Disclosure provides project-level information, allowing impact investors to evaluate the social and environmental benefits generated by specific infrastructure projects. Details about the project's purpose, stakeholders involved, and anticipated outcomes enable investors to assess its alignment with impact objectives and its potential to create positive change.
3. Community Engagement and Well-Being: Municipal bond disclosure promotes community well-being by fostering transparency and accountability. By sharing information about projects, financing plans, and stakeholder involvement, disclosure enables communities to participate in decision-making processes and voice their concerns. This inclusive approach strengthens community engagement, builds trust, and ensures that projects truly meet local needs.
4. Risk Mitigation and Long-Term Sustainability: Transparent disclosure practices contribute to risk mitigation by highlighting potential financial, operational, and reputational risks. It enables investors to assess a municipality's ability to manage risks effectively and achieve long-term financial sustainability. This helps safeguard investor interests while supporting the well-being of the community over the bond's lifecycle.

Municipal bond disclosure has the potential to be a critical tool for impact investors seeking to generate meaningful social and environmental impact alongside financial returns. It could facilitate informed decision-making by providing investors with the necessary information to assess impact risks, evaluate project-specific impact, engage with communities, and promote long-term sustainability. By considering impact risk factors and community well-being through comprehensive disclosure, impact investors could actively contribute to positive change and support sustainable development in U.S. communities.

Part 2 of this series will review The Tower Amendment and published next week.