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Climate change bringing long-term credit risks to states and municipalities

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While several major ballot measures targeting climate change failed during the midterm election, reality will catch up with spiraling costs, which have not been fully captured by the credit rating agencies, according to several market sources.

Although Fitch Ratings said in a report in May that credit downgrades on municipal credits due to climate change have been rare except for the instance of the State of Louisiana and New Orleans after Hurricane Katrina, it will be hard to raise money on the bond market if the risks get worse, said Rachel Cleetus, lead economist and policy director with the Climate and Energy program at the Union of Concerned Scientists.

"The financial sector has to incorporate the risks to make better decisions, but the signals are not available now," Cleetus said.

Meanwhile, Moody's Investors Service embeds climate risks in its existing credit factors but doesn't address it as a credit risk, although it warned about the increasing economic costs of climate change on states and municipalities in a report in November 2017.

Rating agencies focus on cash flows of one to three years, which may not fully capture the risks of a long-term bond of 20 or 30 years, said Paul Herman, CEO and founder of HIP Investor, an impact investing firm in San Francisco. The firm has its own rating methodology that incorporates environmental, social, and human metrics.

Municipal investors will have to be the main driver behind the movement as they would want to know the risks brought by climate change and sea level rises, said John Miller, a water resources engineer and author of the report "Credit Downgrade Threat as a Non-regulatory Driver for Flood Risk Mitigation and Sea Level Rise Adaptation."

Not a lot of investment managers are really looking into climate risks, although the interest is growing, said Robert Fernandez, director of environmental, social, and governance (ESG) research at Breckinridge Capital Advisors.

The firm evaluates ESG risks quantitatively and when the risks are severe enough, it could lead to downgrades on municipal credits, but it doesn't happen often and the adjustment is made on the margin, Fernandez said.

"Rating agencies have upped their games in the last 12 to 18 months. We still haven't seen many examples of rating changes, but this is possible to change in the next few years," added Andrew Teras, senior research analyst at Breckinridge Capital Advisors.

Climate change initiatives stumble during midterm elections

In November, the State of Washington's initiative to levy a carbon emissions fee—the first of its kind in the nation—was rejected by 57% of the voters. Voters in Arizona rejected a measure that requires electric utilities to use renewable energy, and Colorado voted down an initiative that requires a minimum distance of oil and gas facilities from occupied buildings. California also defeated a USD 8.9bn bond referendum to fund water infrastructure projects.

On the other hand, Nevada passed an initiative that requires electric utilities to generate 50% of electricity from renewable resources by 2030. The City of Austin, Texas passed a USD 184m bond proposal to fund flood mitigation and water quality protection.

"What surprised us was not what was passed, but what was not passed," said Eric Glass, a portfolio manager at AllianceBernstein who manages its USD 400m municipal impact portfolio.

While there is no immediate effect on overall credit, municipalities are not doing enough to mitigate the climate risks, especially considering the United Nations' special report in October that warned about the 12-year countdown to combat global climate catastrophe, Glass said.

Escalating costs

A total of 16 weather events cost USD 306.2bn in 2017, breaking the record of USD 214.8bn in 2005, according to the Office for Coastal Management. The Wharton Risk Management Center estimates that the federal government set another record in 2017 by spending more than USD 130bn in disaster relief and debt forgiveness.

While the federal government has played a huge role in stabilizing the affected states, it is not likely to increase the appropriation considering the political dynamic and downward pressures on discretionary spending in the federal budget, Teras from Breckinridge Capital Advisors said.

Maine, Florida, Virginia, Washington, and California are among the most vulnerable states to rising sea levels, according to the sea level rise viewer by the Office for Coastal Management. The states most prone to hurricanes are New York, Florida, Texas, Massachusetts, and New Jersey.

While states and municipalities are taking steps to tackle climate risks, it is unlikely that there is significant risk reduction taking place, said Shalini Vajjhala, founder and CEO of Re:focus, a firm that helps government agencies design and finance infrastructure projects.

Progress has been made by North Dakota on flood mitigation and Texas on coastal protection, but California, for instance, still needs a lot of work on its water utilities and heat reduction, she said.

The Union of Concerned Scientists found that more than 300,000 coastal homes valued at USD 117bn and another 14,000 coastal commercial properties valued at USD 18.5bn will be exposed to chronic flooding by 2045. These properties contribute about USD 1.5bn of property tax today, which will increase to USD 12bn by 2100.

The decline in property values will have a spiral effect that will lead to lost values of the communities and threaten local tax bases, which will be particularly hard for smaller communities with a low-income population that don't have big tax bases to begin with, Cleetus from the Union of Concerned Scientists, said.

“The science is clear, but the market is out of sync with the reality. It increases the potential for sharp adjustment, which will be painful for homeowners, communities, and the wider economy,” Cleetus said.

by Yuanqing Sun