

Frequently Asked Questions:

## The Impact of ESG Disclosure on the U.S. Municipal Market

In early March, the United Nations' Intergovernmental Panel on Climate Change released the latest installment of its continuing reports on the global impacts of climate change, which U.N. Secretary-General Antonio Guterres said contains "an atlas of human suffering." Just a week later, the Municipal Securities Rulemaking Board's (MSRB) comment period closed on the Board's request for information regarding environmental, social and governance (ESG) practices within the more than \$450 billion per year municipal market. MSRB's stated interest for feedback was specifically in regard to disclosure and labeling for a small (about 10% of issuance in 2021) but growing part of Muniland.

The U.S. municipal market still lags the corporate world in ESG disclosure, which itself trails the European Union (EU). There is general consensus that room for improvement in ESG disclosure and labeling exists, as 77% of respondents in a 2021 survey by The Bond Buyer cited the need for a universal set of standards<sup>1</sup>. There is almost no agreement, however, among market participants on how to define ESG with meaningful specificity, let alone implement standardized best practices. The Securities and Exchange Commission (SEC) recently released a draft rulemaking that proposes to require corporate disclosure on climate-related risks and emissions data. Could munis be next?

The world of independent verifiers and alignment opinion providers is akin to the Wild West, leading some issuers to instead self-designate their security as being aligned with a particular environmental or social rubric. Yet even with the fever pitch of interest in ESG, there is thus far no economic benefit to the issuer. Further, as [HilltopSecurities' High Yield team's research noted](#), an ESG-related designation might be nice to have but has no bearing on investor decision-making<sup>2</sup>.

The following is a high-level primer and summary of recent discussions about ESG in the U.S. municipal market, prepared for HilltopSecurities' clients.

### Where did ESG investing come from?

While impact investing has been around for decades, it became better known with the help of the late Kofi Annan during his tenure as U.N. Secretary-General. He brought together the leaders of prominent global financial institutions and related experts, reiterated the existential threat of climate change, and urged them to make a commitment that we, as humans, can do better and do more. About a year after that, in 2006, the Principles for Responsible Investment (PRI) were born. Signatories to the PRI have committed themselves to considering ESG across their business model as it relates to both internal and external stakeholders.

*The U.N. in 2015 adopted 17 sustainable development goals (SDG) that collectively have 169 specific targets and 231 indicators measuring progress towards achieving these goals. ESG shares similar concepts but is more focused on the processes that governments and corporations use.*

### Aren't there already definitions for ESG?

Sort of, though nothing has yet been formally adopted for use by the muni market, which was part of the impetus behind the MSRB's request for information. The U.N. in 2015 adopted [17 sustainable development goals](#) (SDG) that collectively have 169 specific targets and 231 indicators measuring progress towards achieving these goals. ESG shares similar concepts but is more focused on the processes that governments and corporations use. However, greater flexibility means there is no one-size-fits-all for ESG. Standardization is more difficult, and not all concepts translate cleanly to munis. The EU

has adopted a taxonomy to provide more clarity via definitions and guidelines, though the taxonomy focuses on climate-related sustainable finance (mainly the “E”).

## Similarly, aren’t there already standards on disclosure?

Yes, but again nothing that has yet been formally adopted for use by munis. The Task Force on Climate-Related Financial Disclosures (TCFD) is a global effort that outlines recommendations for voluntary disclosure that it believes will help inform investors, lenders, and insurers so they can better incorporate climate risks in their decision-making. The Sustainability Accounting Standards Board (SASB) has developed industry-specific ESG reporting standards supported by guidelines for financial materiality. Both point out that good governance (“G”) and treating employees, customers, and other stakeholders well (“S”) are generally correlated with achieving positive sustainability-related outcomes. However, both TCFD and SASB are generally corporate-focused, as some key concepts don’t translate to munis.

For those who are looking for an eventual global standard that also includes social and governance, the best hope might be an offshoot of the 26th Conference of Parties (COP) in Glasgow. In late 2021, the International Financial Reporting Standards (IFRS) Foundation announced the creation of the [International Sustainability Standards Board](#) with marching orders to establish “high quality, transparent, reliable and comparable reporting by companies on climate and other ESG matters.” IFRS is the international analogue to the Financial Accounting Foundation, parent of FASB and GASB. COP is the annual U.N. conference on climate change. The 21st COP, in France in 2015, remains the best known and is commonly known for the “Paris agreement.”

## What is the SEC proposing, and does it impact municipal disclosure?

The SEC’s March 2022 release proposes that publicly traded companies disclose “information about its climate-related risks that are reasonably likely to have material impacts on its business or consolidated financial statements, and GHG [greenhouse gas] emissions metrics that could help investors assess those risks”<sup>3</sup> as well as any targets, goals or plans for energy transition (i.e. moving to renewable sources from traditional sources).

It would be modeled after the TCFD. The GHG metrics would include Scope 1 and 2 emissions, and if material, Scope 3. That means the company would have to measure and disclose its own GHG emissions (Scope 1) and GHG emissions created directly as a result of the company’s operations, such as its demand on the electric grid (Scope 2). The difficulty lies in measuring Scope 3 emissions, which are GHG emissions created anywhere in that company’s value chain, upstream or downstream, such as by its vendors and suppliers; this may likely include best estimates. It does not speak to social or governance factors and, as proposed, would not be applicable to munis.

## What is the difference between SDGs and ESG?

SDGs generally focus on the impact to the environment or to people by a corporation or government. ESG concepts help inform investors about impacts to the corporation or government itself from environmental, social or governance factors. ESG can be

*The Task Force on Climate-Related Financial Disclosures (TCFD) is a global effort that outlines recommendations for voluntary disclosure that it believes will help inform investors, lenders, and insurers so they can better incorporate climate risks in their decision-making.*

*In late 2021, the International Financial Reporting Standards (IFRS) Foundation announced the creation of the International Sustainability Standards Board with marching orders to establish “high quality, transparent, reliable and comparable reporting by companies on climate and other ESG matters.”*

*SDGs generally focus on the impact to the environment or to people by a corporation or government. ESG concepts help inform investors about impacts to the corporation or government itself from environmental, social or governance factors.*

a useful way of thinking about organizational risk management. For example, some investors wish to know how resilient a muni is to climate risk based on adaptation or mitigation measures the muni has or has not previously undertaken, which is an ESG factor. Another example would be reputational harm and related financial damages caused by a bad actor, such as what happened to some universities from former athletic department employees. Broadly speaking, diligent risk management – including cybersecurity – is part of good governance for any entity and could have devastating outcomes when weaknesses are exposed.

*Broadly speaking, diligent risk management – including cybersecurity – is part of good governance for any entity and could have devastating outcomes when weaknesses are exposed.*

## What is greenwashing?

“Greenwashing” is when a corporation or government is viewed as over-representing the sustainable, social, or other impacts of the security it is offering or mission it is undertaking, potentially to the point of being misleading. The tightrope that munis walk is that one could argue the core functions of many munis have always had a legitimate environmental or social benefit, including drinking and clean water, affordable housing, education, and not-for-profit healthcare, even without an additional designation to the labeling of their bonds. Meaning some muni bonds may already lend themselves to the virtues of ESG without having to do anything extraordinary.

## You mentioned labeling of the bonds, but there are so many external ESG opinion providers. Moreover, some issuers just self-label their bonds. What should we do?

Start by talking to your HilltopSecurities advisor to weigh factors such as the economics of pursuing an opinion and any related disclosure and reporting commitments. As noted, there are no uniform standards adopted yet for munis, and opinion providers currently operate in a highly competitive and unregulated market.

*The tightrope that munis walk is that one could argue the core functions of many munis have always had a legitimate environmental or social benefit, including drinking and clean water, affordable housing, education, and not-for-profit healthcare, even without an additional designation to the labeling of their bonds.*

There are multiple types of opinions, and costs vary, especially as these products overlap with one another: 1) third party assurances, in which an entity such as an accounting firm assesses how closely the bond issuance aligns with generally accepted methodologies for impact investing, such as the International Capital Market Association’s [Green Bond Principles](#), [Social Bond Principles](#) or [Sustainability-Linked Bond Principles](#); 2) second party opinion, in which an environmental finance consultant or a financial industry representative like a rating agency or bond insurer evaluates the project or asset being financed and – based on certain key performance indicators defined in the offering document – how much environmental or social impact the outcome could reasonably have. The key performance indicators are typically tied to SDGs but don’t have to be. Think of the latter as an opinion as to the “green-ness” of the proposed issue.

It is also important to consider that including these pre-sale opinions in the offering might create expectations that the issuer intends to produce ongoing monitoring and reporting after the bonds have been sold. This means measuring actual impacts over time versus what was represented pre-issuance, and probably retaining one of those opinion providers—perhaps the same one—to audit and report the results for the benefit of bondholders and other interested parties. You should ask counsel to

*Start by talking to your HilltopSecurities advisor to weigh factors such as the economics of pursuing an opinion and any related disclosure and reporting commitments.*

opine, but climate risks are not currently required under the Securities and Exchange Commission's Rule 15c-212 continuing disclosure requirements. ESG proponents may still view robust voluntary disclosure and transparency as part of good governance.

## With such an array of opinions and self-labeling options, what do market participants want to see in disclosure?

The MSRB in March 2022 received comments from about four dozen respondents, though many were professional organizations responding on behalf of large membership bases. The SEC, not the MSRB, would be the ultimate regulatory authority. Most respondents were conceptually supportive of guidance for voluntary best practices, such as what the GFOA adopted in 2021<sup>4</sup> and 2022<sup>5</sup>. SIFMA, for example, noted that "neither the issuer nor the underwriter is in a position to determine whether the issuer's ESG-related factual disclosures are sufficient for the bonds to be ESG-labeled bonds under any specific investor's criteria . . . While external review of a designation may be beneficial, self-designation should still be viewed as credible for ESG consideration as long as the issuer discloses a detailed rationale for their self-designation that is consistent with a widely accepted framework, including a clear breakdown of the planned use of proceeds."<sup>6</sup>

The National Association of Bond Lawyers noted that municipal market disclosure ". . . continue[s] to evolve. Regulation or standardization is premature, may be cost-prohibitive for small issuers, and could hamper the market's ability to address emerging ESG concerns."<sup>7</sup>

From an issuer's point of view, New York City responded to the MSRB by saying "The problems confronting the thousands of bond issuers across the country are often vastly different, unforeseeable, and often unquantifiable, and need to be considered in the context of each issuer's particular circumstances. While there is no one-size-fits-all approach, clearer standards as to what constitutes 'green' or other ESG-labeled bonds could provide more clarity to issuers, improve investor acceptance, and potentially lead to a pricing advantage for these bonds. In any event, issuers should provide specific details about their ESG challenges and their current and expected impact on future operations and financial stability if they are material."<sup>8</sup>

## Whether externally reviewed or self-labeled, is there any economic benefit to ESG bonds for the issuer?

Generally there is no evidence of pricing difference among traditional bonds and ESG-labeled bonds (either externally reviewed or self-labeled). Reasons include the lack of standardization in definitions, metrics, and disclosure as well as market forces like supply and demand. Currently ESG factors are not material to the primary and secondary markets unless they were factors already considered to be material and relevant to the issuer's credit profile. There are some institutional investors for whom ESG considerations are one part of the overall strategy. ESG factors are, however, included in the overall analysis of the rating agencies (see below).

*You should ask counsel to opine, but climate risks are not currently required under the Securities and Exchange Commission's Rule 15c-212 continuing disclosure requirements. ESG proponents may still view robust voluntary disclosure and transparency as part of good governance.*

*The MSRB in March 2022 received comments from about four dozen respondents, though many were professional organizations responding on behalf of large membership bases. The SEC, not the MSRB, would be the ultimate regulatory authority.*

*Generally there is no evidence of pricing difference among traditional bonds and ESG-labeled bonds (either externally reviewed or self-labeled). Reasons include the lack of standardization in definitions, metrics, and disclosure as well as market forces like supply and demand.*

## Why is what the EU does so influential to munis?

The EU was the first to raise the topic of climate and ESG, the first to mandate climate-related disclosure, and just like Dodd-Frank did for the SEC in 2010, so did the European Securities and Markets Authority (ESMA) expand its regulatory authority over the credit rating agencies (CRAs) in 2011. By 2019, ESMA began requiring greater transparency as to whether ESG factors were a key driver in a credit rating action.

Why does that matter for U.S. munis? CRAs are global companies. The three CRAs that are most often utilized for U.S. muni bond ratings are either based or have affiliates in Europe, meaning they must register with ESMA if they want to do business there. Under ESMA rules, the EU location of the CRA must endorse (i.e. stand behind) any rating assigned by an office outside of the EU - including the United States. The endorsement means the CRA is representing to regulators that rigorous, transparent and conflict-free analytics were done regardless of where the rating was assigned. Securities for the most part can be bought, sold, or held globally. This includes, for example, taxable U.S. munis. Meaning because of ESMA rules for endorsed ratings, rating agencies here in the U.S. must incorporate ESG factors into their analyses whenever material and relevant, no matter where the bondholder is located, even for munis.

*The EU was the first to raise the topic of climate and ESG, the first to mandate climate-related disclosure, and just like Dodd-Frank did for the SEC in 2010, so did the European Securities and Markets Authority (ESMA) expand its regulatory authority over the credit rating agencies (CRAs) in 2011.*

## How do the rating agencies view ESG? Is it a separate rating?

In 2019 Fitch Ratings, followed by Moody's Investors Service in 2021, began including relevant ESG factors along with numeric scores in their U.S. public finance rating reports. The Fitch relevance scores and Moody's credit impact scores are themselves not ratings, but rather highlight credit factors that are both material to the rating and carry relevance to one or more ESG factors. Not all credit factors are driven by ESG characteristics and not all ESG characteristics are material to the rating. In most cases, ESG factors are neutral or negative to credit quality, rarely positive. S&P Global Ratings announced it will also begin publishing ESG scores in public finance, phasing them in based on issuer type, with expected completion sometime in 2023.

*Not all credit factors are driven by ESG characteristics and not all ESG characteristics are material to the rating. In most cases, ESG factors are neutral or negative to credit quality, rarely positive.*

## Contact Us

Please contact your HilltopSecurities investment banker or representative for more information, or email us at [info@hilltopsecurities.com](mailto:info@hilltopsecurities.com).

### **Ted Chapman**

Investment Banking Analyst

214.859.1067

[ted.chapman@hilltopsecurities.com](mailto:ted.chapman@hilltopsecurities.com)

## References

1. Funk, Lynne. "ESG and the Muni Market: Focusing the ESG Lens on Munis." The Bond Buyer (Oct. 2021).
2. Rattner, Yaffa, et. al. "High Yield Impact Survey." Hilltop Securities Inc. (Dec. 27, 2021)
3. SEC "The Enhancement and Standardization of Climate-Related Disclosures for Investors." Release Nos. 33-11042; 34-94478; File No. S7-10-22 (March 21, 2022).
4. Government Finance Officers Association. "Best Practices | Voluntary Disclosure." (Oct. 1, 2021)
5. GFOA. "Best Practices | Marketing Municipal Bonds as Green, Sustainable, Social, or Other Alternatively Designated Bonds." (Mar. 4, 2022)
6. Securities Industry and Financial Markets Association: Letter from Leslie M. Norwood, Managing Director and Associate General Counsel, dated March 8, 2022
7. National Association of Bond Lawyers: Letter from Ann D. Fillingham, President, dated March 7, 2022
8. City of New York, Office of the Comptroller: Letter from Marjorie E. Henning, Deputy Comptroller for Public Finance, dated March 7, 2022

*The paper/commentary was prepared by HilltopSecurities (HTS). It is intended for informational purposes only and does not constitute legal or investment advice, nor is it an offer or a solicitation of an offer to buy or sell any investment or other specific product. Information provided in this paper was obtained from sources that are believed to be reliable; however, it is not guaranteed to be correct, complete, or current, and is not intended to imply or establish standards of care applicable to any attorney or advisor in any particular circumstances. The statements within constitute the views of HTS as of the date of the document and may differ from the views of other divisions/departments of affiliate Hilltop Securities Inc. In addition, the views are subject to change without notice. This paper represents historical information only and is not an indication of future performance. This material has not been prepared in accordance with the guidelines or requirements to promote investment research, it is not a research report and is not intended as such. Sources available upon request.*

*Hilltop Securities Inc. is a registered broker-dealer, registered investment adviser and municipal advisor firm that does not provide tax or legal advice. HTS is a wholly owned subsidiary of Hilltop Holdings, Inc. (NYSE: HTH) located at 717 N. Harwood St., Suite 3400, Dallas, Texas 75201, (214) 859-1800, 833-4HILLTOP*