FINANCIAL INNOVATIONS LAB®

Integrating ESG Data to Improve Risk Management and Municipal Resilience

Report Background and Overview

As municipalities increasingly confront the costs and consequences of rising global temperatures and significant social challenges, local governments must integrate these risks more effectively into their capital planning, budgeting, and asset management processes to account for and mitigate these risks adequately.

Because annual budgets cannot fund significant resiliency improvements all at once, local governments will often issue municipal (muni) bonds to raise necessary capital. As the pool of investors seeking sustainable investment opportunities grows, municipalities are keen to take advantage of the momentum to attract new capital sources to finance their resiliency efforts.

Capitalizing on this opportunity begins with designing projects informed by and in response to environmental, social, and governance (ESG) factors or non-financial considerations that can help more holistically assess the project or investment's risk or impact. Unfortunately, local governments raising capital, or municipal issuers, currently have limited options to aggregate, analyze, and operationalize existing or collect new ESG datasets. The most acute barriers preventing governments from utilizing data include:

- **Incomplete and Inconsistent Data:** Sustainable municipal bond issuances have yet to adhere to a single reporting framework. This makes it more difficult for investors to efficiently locate the data they need to evaluate and compare bonds and contributes to the lack of post-issuance reporting on the use of proceeds and outcomes.
- **A Lack of Strategic Risk Management:** Poor communication and siloed operations within local government are major hindrances to data collection and wider data sharing.
- **Inconsistent Disclosures:** Disclosure requirements are not standardized, resulting in inconsistencies in ESG risk reporting.
- **Education and Resource Gaps:** Translating key ESG data points into language that a broad set of stakeholders can understand is difficult without experienced professionals. But developing in-house business units can be prohibitively expensive, especially for smaller issuers. Additionally, a greater understanding of the difference between risk and impact and the distinct datasets required to demonstrate each is needed.

Integrating ESG Data to Improve Risk Management and Municipal Resilience summarizes the research and key findings of a Financial Innovations Lab®, conducted by the Milken Institute's Innovative Finance and Center for Financial Markets teams in April 2022. The Lab brought together issuers, credit rating agencies, data providers, investors, regulators, and underwriters to develop recommendations to help advance the market.

Solutions Overview

Lab participants discussed various options to address the barriers currently hindering robust planning and funding of municipal ESG bonds and the most promising recommendations for upstreaming ESG risk mitigation efforts.

Solution 1: Establish a Risk Management System

- To address existing and future risks more strategically and systematically, municipal issuers can employ an Enterprise Risk Management (ERM) approach by identifying vulnerable areas and potentially high-risk situations early and unilaterally executing mitigation strategies based on the profile and size of risk. Once a strong governance framework that outlines risk sharing is established, municipalities can add detail to their budgets with specific examples of what type of data are required, how to collect it, what technology is necessary, and how to operationalize all of this in day-to-day decisions.
- As a first step to conducting a comprehensive ESG risk assessment, Lab participants organized data collection efforts into three categories: information currently available internally, information that an issuer could reasonably obtain, and data that can only be found through a third party, like biodiversity risk. Collaborating with other government entities, NGOs, and academic institutions could help cost-effectively fill data gaps.

Solution 2: Build a Technology Platform to Centralize Data

- Lab participants discussed the benefits of aggregating publicly available data into a central, dedicated ESG data platform to improve coordination and transparency among agencies. Key considerations of this platform include ease of access to data, having the data integrate into their internal investment processes, and embedding technology that produces "machine-readable" and up-to-date information.
- Governmental agencies, NGOs, and academic institutions can facilitate access to alternative datasets with untapped ESG utility and bring these data to market through private-sector partnerships.
- Understanding and assuring issuers of the external data use case may encourage agencies to publish holistic, and in some cases changing, datasets that reflect total impact without fear of legal repercussions.
- For municipalities without the budget to pay for a centralized solution, federal, state, or local funding streams could be leveraged through multiyear budget agreements. Additionally, monetizing data through pricing tiers could create a revenue source to fund a portion of the platform.

Solution 3: Create Centers of Excellence for Coordination

- Since the risks and potential impacts of ESG factors differ across the country, a regional or function-based approach can help municipalities develop more accurate and relevant risk assessment frameworks according to their location or industry.
- While the lion's share of the work should be executed at the regional level, federal incentives could be

layered on for successful regional coordination. This presents an opportunity for the federal government to establish Regional Deployment Accelerators to help communities access federal predevelopment capital or technical assistance to improve data tracking and outcomes.

Solution 4: Utilize New and Existing Disclosure Platforms

- Since there is no ESG equivalent of the generally accepted accounting principles (GAAP) information required for financial statements, filling existing data gaps through the use of sector-specific investor engagement letters addressed to municipal issuers could help to outline explicitly which metrics they are looking for. Lab participants agreed that power utilities and water authorities were well-positioned to take the lead in this arena, as their reporting requirements are already somewhat uniform.
- Integrating ESG concerns into Annual Risk and Impact Statements published by issuers that demonstrate to investors how each project considers all material risks can be the first step towards an ERM system.

Solution 5: Recognize and Reward Innovation and Excellence

- Incentivizing municipal governments to adopt these practices through a prize that awards best-in-class resiliency projects and associated bond issuances can help inspire other issuers to take similar action.
- Announcing the recipients at high-profile events like the Bond Buyers Dinner or Milken Institute Public Finance Forum will bring attention to the winning entries and the importance of cooperation and coordination within the municipal bond space overall. A leadership council of past winners could highlight a new class of sustainability experts who can share best practices and lessons learned during the process.

Conclusion

If the municipal bond market is to capitalize on the sustainable investing momentum, it will require coordinated efforts from all stakeholders to standardize data about material risks and look at ways to "upstream" ESG risk detection by embedding these concerns into existing government practices on budgeting, asset management, planning, and procurement.

View the full report at ***www.milkeninstitute.org/report/esg-data-integration-municipal-resilience-risk***