FitchRatings

2020

ESG IN CREDIT

Evaluating ESG Risks in Public Finance

WHITE PAPER

Evaluating ESG Risks in Public Finance

Related Research

ESG. RS Compendium:
US Public Finance
International Public Finance

ESG Sector Heat Maps:
Public Finance & Infrastructure

Templates Compendium:
ESG Sector Template Compendium

Given the nature of public finance entities, Environmental, Social and Governance (ESG) risks generally have a lower level of direct impact on credit than other asset classes analyzed by Fitch.

Fitch assesses 14 ESG factors for public finance entities that are not tax-supported (such as U.S. revenue-supported and not-for-profit entities and government-related entities outside of the U.S.), the same factors assessed for Corporates and Financial Institutions. Fitch assesses a modified set of 15 ESG factors for tax-supported entities such as regional and local governments (including U.S. States). These reflect fundamental differences in the types of ESG factors that affect the credit profile of tax-supported entities, such as Human Rights and Political Freedoms, Public Safety and Security, and International Relations and Trade.

Governance is the most influential ESG risk factor across the overall public finance ratings portfolio.

Governance is the most influential ESG risk factor across the overall public finance ratings portfolio. Some of the most visible credit rating actions over the past few years have focused on Governance issues, including on the Commonwealth of Puerto Rico, PREPA and the State of Rio de Janeiro.

Social and Environmental risks are of similar importance in terms of credit impact for public finance issuers. Planning to anticipate or resolve Social and Environmental impacts is usually within the control of public finance entities' management, provided the financial wherewithal exists to support this effort. Consequently, most credits have been able to manage these risks effectively. The most impactful elements within Social and Environmental categories are:

- Biodiversity and natural resource management and demographics for tax-supported entities.
- Exposure to environmental impacts and labor relations and practices for revenue-supported U.S. public finance issuers.

Sector-Specific ESG Factors for Major U.S. Public Finance Sectors (Non-Tax Supported)

ENVIRONMENTAL	U.S. Public Finance Health Care	Public Power	Higher Education
GHG Emissions & Air Quality	Emissions from operations		
Energy Management	Energy use in operations	Fuel used to generate energy and serve load	Energy management and use in operations
Water & Wastewater Management	Water use in operations	Water used by hydro plants or other generating plants; effluent management	Water use, consumption; availability of resources
Waste & Hazardous Materials Management; Ecological Impacts	Management of medical waste	Impact of waste from operations	Land planning and development; project development and construction
Exposure to Environmental Impacts	Business disruption from climate change; environmental impacts changing human health requirements	Plants' and networks' exposure to extreme weather events	Exposure to extreme weather events that disrupt operations (e.g. damage to physical assets)
SOCIAL			
Human Rights, Community Relations, Access & Affordability	Low-income patient access	Product affordability and access	Relationships with local communities; access and affordability
Customer Welfare - Fair Messaging, Privacy & Data Security	Data privacy; care quality and safety outcomes; controlled substance management; pricing transparency	Quality and safety of products and services; data security	Data security and privacy; fair marketing of cost and educational outcomes
Labor Relations & Practices	Impact of labor negotiations and employee (dis)satisfaction; recruitment and retention of skilled healthcare workers	Impact of labor negotiations and employee (dis)satisfaction	Impact of labor negotiations and employee (dis)satisfaction; employee recruitment and retention; workforce diversity
Employee Well-being	Worker safety and accident prevention	Worker safety and accident prevention	Worker safety and accident prevention
Exposure to Social Impacts	Social pressure to contain healthcare spending growth; sensitive political environment with impactful legislative changes	Social resistance to major projects that leads to delays and cost increases	Social- or consumer-driven changes impacting demand and/or public support
GOVERNANCE			
Management Strategy	Strategy development and implementation		Management's effectiveness in executing strategy and mission components; ability to manage through a cycle
Governance Structure	Board independence and effectiveness; ownership concentration	Governing body independence and effectiveness; degree of political or external influence	Board independence and effectiveness in fiduciary and strategic efforts; ownership concentration; span of control
Group Structure	Complexity, transparency and related-party transactions		
Financial Transparency	Quality and timing of financial disclosure		Quality, timeliness, frequency, reliability level of detail, and scope of financial disclosure

Sector-Specific ESG Factors for Local Governments and U.S. States (Tax Supported)

ENVIRONMENTAL

GHG Emissions & Air Quality	Emissions and air pollution as constraints on economy and revenue growth; enforcement/compliance with governmental/regulatory standards
Energy Management	Impact of energy resources management on economy and governmental operations, including enforcement/compliance with governmental/regulatory standards
Water & Wastewater Management	Water resource availability impacts on economy and governmental operations, including enforcement of governmental/regulatory standards
Biodiversity and Natural Resource Management	Impact of natural resources management on economy and governmental operations
Exposure to Environmental Impacts	Impact of extreme weather events and climate change on economy, governmental operations and policy related to natural disasters treatment

SOCIAL

Human Rights and Political Freedoms	Policy framework on social stability and human rights protection
Human Development, Health and Education	Impact of health and education on economic resources and governmental operations
Labor Relations & Practices	Impact of labor negotiations and employee (dis)satisfaction
Public Safety and Security	Impact of public safety and security (including cyber security) on business environment and/ or economic performance
Population Demographics	Impact on economic strength and stability (labor force supply, household income, population and aging, etc.)

GOVERNANCE

Political Stability and Rights	Impact of political pressure or instability on operations; tendency toward unpredictable policy shifts
Rule of Law, Institutional & Regulatory Quality, Control of Corruption	Government effectiveness; control of corruption; regulatory quality; management practices and their effectiveness; respect for property rights
International Relations and Trade	Trade agreements and impact on economy and revenue growth
Creditor Rights	Willingness to service and repay debt; exposure to outstanding or pending litigation
Data Quality and Transparency	Limitations on the quality and timeliness of financial data, including transparency of public debt and contingent liabilities

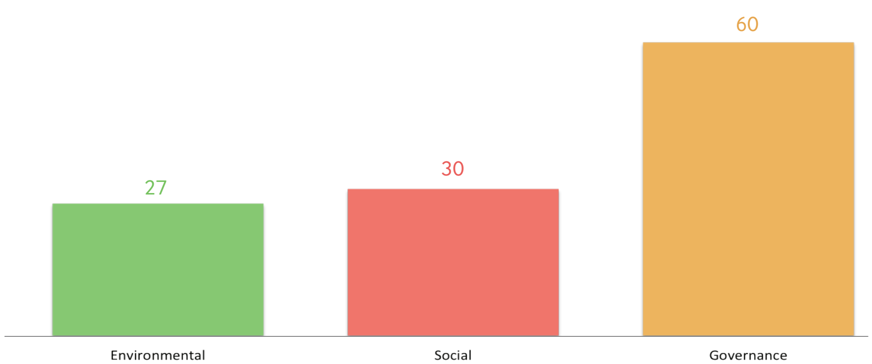
ESG Relevance Scores In Public Finance Ratings: Key Facts And Findings

Fitch's initial round of ESG Relevance Scoring for more than 2,000 USPF issuers shows that 5% of ratings featured at least one elevated ESG Relevance Score ('4' or '5'). The percentage of USPF issuers with an elevated ESG Relevance Score ranges from 3% for local governments to 14% for states. Environmental factors have a relatively low influence in USPF ratings, mainly due to the U.S. federal government's financial support to areas affected by hurricanes, floods, wildfires and other high-cost weather events.

For state and local governments, elevated ESG scores were largely concentrated within the Social and Governance risk elements and mostly related to below-standard features that work asymmetrically and negatively affect ratings. Higher ESG Relevance Scores were observed in some revenue sectors, such as Life Plan Communities and Water and Sewer entities, where ratings exhibit higher sensitivity to shifts in consumer demand, political influence, affordability/access considerations, and cost drivers associated with regulatory requirements or consent orders.

The percentage of USPF issuers with an elevated Relevance Score generally ranges from 3% to 4% across most sectors.

USPF - ESG Elements Driving Issuer Credit Impact



Source: Fitch Ratings, scores at launch time

The analysis of ESG Relevance Scores for the 366 public finance issuers outside of the U.S. shows that ESG risks have more influence on the Local and Regional Governments' (LRG) rating decisions, with about 10% of LRGs having ESG Relevance Scores of '4' or '5'. These cases mostly relate to Governance and, in particular, to political instability and rights and creditor rights. This is often a risk cited for emerging-market countries.

Environmental risk is also a key factor, relating primarily to biodiversity and natural resource management, which affects LRGs with tax bases concentrated in natural resource exploration. This could often lead to revenue concentration and volatility, which are important rating drivers and negatively influence the stability of revenue flow.

As for Government Related Entities (GREs) outside the U.S., Fitch generally did not identify ESG issues that impact the current ratings and the majority of ESG scores for GREs were assessed at '3'. This is likely due to the government support of GREs, which mitigates ESG issues.

Spotlight: Labor Relations and Environmental Risk in Public Finance

Labor Relations

Local governments, hospitals, colleges and universities are highly labor-intensive, so undue pressure derived from the relationship between management and the workforce can create overall financial stress that could affect ratings. For most rated U.S. Public Finance entities, this relationship is cooperative and flexible enough that it does not affect the rating, resulting in a Relevance Score of '3'. However, Fitch has identified labor relations and practices as strained enough to yield a Relevance Score of '4' in a limited number of cases within U.S. Public Finance, indicating that the entity's ability to adjust spending could become constrained enough to lead to a rating change.

In a handful of cases, labor pressure has been severe enough to result in strikes or work stoppages. Many states prohibit public sector strikes for some or all classes of employees, so these are unusual. Labor contracts that are subject to binding arbitration can create a similar level of expenditure pressure on rated entities, since the ultimate control over labor settlements is out of the hands of management. However, the bargaining framework and status of actual contractual agreements are only inputs into Fitch's analysis of the impact of labor on ratings; they do not fully determine the assessment. Rather, Fitch believes the level of cooperation among the parties and their demonstrated commitment to sound financial operations are the most important indicators of a government's ability to make adjustments necessary to maintain rating stability.

Environmental Risk

Fitch's ratings on U.S. public finance issuers do not reflect the assumption that the federal government would broadly guarantee or step in on an ad hoc basis to cure an individual issuer's financial distress following a natural disaster. However, Fitch considers the longstanding role of the federal government, acting through FEMA, in providing financial assistance to public entities impacted by natural disasters as critically important to rating stability in the presence of these events.