Why stranded assets are more than fossil fuels

Planning for climate change is vital for municipalities looking to issue debt, as some regions are increasingly vulnerable to the financial repercussions of natural disasters.

Human intervention has long had the ability to cause assets to lose value before the end of their economic lifecycle, due to regulation, disruptive innovation and social pressure. Yet increasingly, a factor mankind has little control over is putting asset valuations at risk: climate shock.

Amin Rajan, chief executive of CREATE Research¹ and author of a new BNY Mellon Investment Management-commissioned report,² says the notion of stranded assets, or assets that become devalued due to outside influence, is well represented in the effect of climate change on the value of real estate near coastlines and farmlands prone to drought.

Although it can be hard to gauge where and when a natural disaster will strike, climate change implications do not go unnoticed by investors.

Incidence rates of extreme weather events have been on the rise. In 1980, roughly 250 extreme weather events were recorded globally while in 2018, the number had risen nearly fourfold to 848. The economic and social damage produced by these events was severe. For instance, three hurricanes in the US and Puerto Rico during the 2017 hurricane season resulted in a combined $265bn in damages.³ If, as it is widely believed, the impacts of climate change get worse over the next five years, the cost to municipalities affected will only get higher.

Economic outcome

Dan Rabasco, head of municipal bonds at Mellon, says: “Climate change implications are emerging as important factors for municipal credit quality. The rating agencies and some investors are considering unique environmental threats across different geographies; including droughts, floods and hurricanes.”

While rising sea levels can lead to increased property damage and infrastructure costs along coastal cities and towns, higher temperatures may be detrimental to crop yields in agricultural regions. They could also provoke higher energy demands in order to fuel air conditioning. Both threats hold the potential to adversely impact the financial profile of municipalities – resulting in lower tax revenue, increased expenses and higher leverage.

Over time, the level of climate shock preparation municipalities engage in will become more important in determining valuations of the municipal debt they issue. However, at the moment, the municipal bond market has yet to differentiate between state and local governments with plans in place and those without, according to Rabasco.

He continues: “We believe the municipal bond market has not discounted the valuations of debt issued by municipalities that will be more susceptible to climate change impacts, which makes thorough credit analysis more important than ever.”

¹ BNY Mellon and CREATE Research are unaffiliated entities.
² Future2024: Future-proofing your asset allocation in the age of mega trends. September 2019
³ The Balance: How Hurricanes Damage the Economy. June 25, 2019
So what’s being done?

Since the US federal government exited the Paris Agreement on climate change and mitigation, some states and local governments have taken it upon themselves to meet Paris Accord targets in an attempt to offset the severity of inevitable natural disasters.

**Percent of major US cities that have or anticipate soon having climate sustainability plans**

![Chart](chart.png)

Source: Citi Research, Moody’s May 13, 2019

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Over the long term, regions along the coastal Northeast, beach towns in Georgia and the Carolinas as well as towns and cities that make up the Gulf of the US will see increasing threats to coastal infrastructure. Meanwhile, farming hubs in Texas, Arizona and parts of the Midwest and the Great Plains are likely to see reduced agricultural yield.4

Mayors of local municipalities in most of those regions have a national climate action agenda, with the highest concentration of participants on the East Coast and the Gulf Coast as well as the Midwest and the West Coast.5 Founded in 2014, the Mayors National Climate Action Agenda is comprised of an association of mayors, who represent 427 cities,6 with the goal of reducing greenhouse gas emissions. These are ambitious goals that will need funding to achieve.

“Capital in the form of municipal bonds will be required to fund these initiatives and also repair existing damage to infrastructure,” Rabasco says. “In the face of the growing environmental threat, it is important for long-term investors not only to consider the geographic location of a municipality but also focus on the extent of its strategic planning, fiscal resources and financial flexibility.”

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4 Source: GAO, Climate Change, September 2017
5 Mayors National Climate Change Agenda
6 Climate mayors: Members, 2017
To inform the BNY Mellon Investment Management Future 2024 report, Rajan interviewed leading asset allocators around the world and asked how they are incorporating stranded assets into their forecasts.

Rajan says: “Currently, intensive engagement and collaboration with their investee companies [or municipalities] is the principal response. The mantra is: act like an owner. This is in the belief that those who are part of the problem can also be part of the solution.”

Rajan’s findings prove especially pertinent in relation to the steps municipalities are taking to limit their environmental footprint, as well as their creation of reaction plans to natural disasters.
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