Policy Note: California State Bond Policy and Climate Risk

Background
California, like most state and local governments, finances a significant portion of its long-term infrastructure investments through the issuance of general obligation bonds. The funds generated by the sale of these bonds – exceeding $70 billion outstanding in each of the past three years, compared to annual state budget expenditures of approximately $200 billion – is used to pay for a wide range of state investments, including investments in state buildings, transportation infrastructure, and natural resource management.¹

Financial regulators have begun to recognize the connection between public bond issuance and climate change-related risks. In 2018, California Treasurer John Chiang signed the Green Bond Pledge, committing the state to establish a strategy for green bonds (bonds designated for environmentally friendly or sustainable projects, typically certified by a third party) and to issue infrastructure bonds as green bonds wherever applicable.² In a series of reports, the Treasurer outlined the links between California’s climate policies, investment policies, and climate risks – including both climate-related physical risks to state infrastructure investment and climate-related financial risks to public and private investors.³ In addition, federal financial regulators and investors have called for greater climate-related disclosures in general and in public bond offerings in particular, acknowledging the significant climate-related risks facing many municipal issuers and the associated risks potentially facing bond investors.⁴

One example of recent climate-related bond policy proposals, Assembly Bill 1500 (E. Garcia, 2021), would authorize the issuance of $7 billion in state general obligation bonds to fund climate resilience projects including investments in wildfire prevention, drought preparation, drought preparation, drought preparation,

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² Green Bond Pledge available at https://www.treasurer.ca.gov/greenbonds/milken.jpg.
and extreme heat mitigation. A provision of the bill would require alignment with climate-resilient finance best practices: “Bonds issued under this division shall, whenever practical, be aligned with generally recognized principles and best practice guidelines for financing climate mitigation, adaptation, or resilience projects.” While the bill has not become law and the impact of such a requirement is unclear at this time, the proposed language further emphasizes growing recognition of the need to consider and address how the state bond program could contribute to climate change-related mitigation, adaptation and resilience and to otherwise address climate risk.

The state has the ability to drive multiple goals in its capacity as an issuer and as a legislative body through policies focused on climate-related risks. (Under Article XVI of the State Constitution, the legislature has the general authority to craft the substantive terms and requirements of new bond issuances as appropriate, with no apparent requirement to focus only on maximizing financial returns.) These goals include:

- Driving greater investment in sustainable, climate-friendly, and climate risk-resilient infrastructure;
- Capturing market premiums from investors actively seeking environmentally aligned investment opportunities;
- Protecting the state from potential adverse financial impacts from the failure to properly account for climate-related risks in issuance; and
- Advancing the state’s and investors’ understanding of climate-related risks throughout the state’s investment and infrastructure portfolio.

Green bond initiatives arguably advance the first two of these goals, and state disclosure of climate risks in its role as an issuer could potentially advance the middle two.

Proposal
California could potentially advance the last goal through a different approach: mandating climate-related risk disclosure by recipients of funds generated via bond issuances. Such a policy could provide the state a wealth of information on the climate-related risks facing state-funded infrastructure, helping the state prepare to address high-risk projects in its role as steward of public assets and informing state efforts to enhance the resilience profile of future investment efforts and select lower-risk alternatives.

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5 Available at https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=202120220AB1500.
The policy is unlikely to affect the salability or pricing of bonds in any meaningful negative way, since risks would be reported post-issuance and would be project or recipient-related – whereas the state’s ability to repay the bond debt, which is investors’ primary concern, is based on the state’s general obligation pledge and is not impacted by project performance. However, the policy would deliver information of substantial importance to the bond program by helping the state’s investors (and the state itself) identify climate risks throughout bond-funded investments. After multiple rounds of expenditure and disclosure, this would improve the quality of investment decision-making and drive state funds toward more resilient projects, saving money in the long term through reduced borrowing costs, expansion of the state’s investor base, and/or improved liquidity for the state’s bonds in the marketplace.

The requirement could be crafted as language available to insert into any bond legislation, potentially applied to all bond issuances, or only to those that would fund infrastructure with significant climate vulnerabilities and/or climate resilience roles. (Such an approach may be preferable to enacting the requirement via a stand-alone, generally applicable law, given the political challenges inherent to creating broad new mandates.)

It could either require state and local agencies receiving bond proceeds to obtain climate-related risk disclosure from eventual contracting parties, or require those agencies to assess and disclose the climate-related risks facing specific projects they plan to fund with the proceeds. (The former could potentially rely on existing corporate disclosure regimes such as the Task Force on Climate-Related Financial Disclosures, while the latter would require a new project risk disclosure framework.) In either case, the requirement should include a minimum threshold for application, at least in the initial phase applying only to sufficiently large projects or sufficiently large contracting parties to maximize the value of the information and minimize undue burdens.

Proposed Legislative Text

(###) Before approving a grant or contract pursuant to this division [in an amount greater than $______], an administering state agency shall obtain a written assessment by the grantee or contractor of any climate-related physical risks anticipated to affect materially the goods or services provided under the covered grant or contract, and any climate-related financial risks anticipated to affect the grantee or contractor’s capacity to perform under the grant or contract, as applicable. The department shall not approve any grant or contract pursuant to this division unless it has reviewed and approved as satisfactory the assessment prepared pursuant to this subdivision. For the purposes of this subdivision, “climate-related physical risk” means risk of physical disruption or damage due to climate change-related impacts, including but not limited to wildfire, flooding, sea-level rise, drought, extreme heat, and extreme weather. For

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the purposes of this subdivision, “climate-related financial risk” means material risk of harm to immediate and long-term financial outcomes due to climate change, including, but not limited to, risks to corporate operations, provision of goods and services, supply chains, employee health and safety, capital and financial investments, institutional investments, financial standing of loan recipients and borrowers, shareholder value, consumer demand, and financial markets and economic health.