IN FOCUS
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California wildfires: potential impacts on municipal credit

The rampant wildfires in Los Angeles have caused devastating loss of life and property. As of this writing, the wildfires have burned for three days and remain uncontained. The fires have destroyed or damaged thousands of homes, businesses and other properties. Some estimates suggest this could become one of the most destructive and costly natural disasters in history – with potential for economic losses at close to $50 billion.

Update from the
Nuveen Municipal Credit Research Team

Assessing climate risk and disaster readiness has always been a key part of our credit quality research. Since California is one of the largest states and issuers of municipal bonds, we recognize that our clients may have questions about any implications for our investments.

While it is far too early to fully assess the ultimate damage and destruction wrought by the wildfires in southern California, Nuveen believes the municipal obligations of the communities impacted by the devastation should remain sound investments, and we do not anticipate payment defaults on these bonds. This view is based on our observations of the municipal market following different types of natural disasters in the United States over time.

HOW HAVE MUNICIPAL BONDS FARED DURING PAST NATURAL DISASTERS?

Past natural disasters, even unprecedented large-scale events like this one, have not precipitated municipal bond payment defaults or long-term credit quality deterioration. Examples include Hurricanes Katrina, Maria, Irma, Harvey and Helene, Superstorm Sandy, and the 2017 California wildfires. Also, while not a natural disaster, the Covid pandemic caused unprecedented shutdowns and disruption, yet municipal bond payments were generally not interrupted.

I HAVE BONDS WITH PAYMENT DATES IN THE NEAR FUTURE. WHAT WILL HAPPEN TO THOSE PAYMENTS?

Bondholders concerned about the proximity of this event to upcoming debt service payment dates can take a measure of comfort in that many municipal obligations are funded well in advance of their payment dates. Property taxes for general obligation (GO) debt service typically work this way, as do obligations like sales taxes and water & sewer debt.

Also, while natural disasters are never good for economies and are often tragedies, they may result in sales tax collection spikes during the recovery phase as insurance/disaster recovery funds are spent on building supplies. Moreover, revenue pledges like sales tax and water & sewer obligations may often draw upon reserve funds should there be a deficiency of collections due to the wildfires.

HOW HAVE MUNICIPALITIES IN CALIFORNIA FARED DURING PAST WILDFIRES?

Historically, assessed valuations of property have held up well when impacted by wildfires. After the wildfires in 2017, some school districts received an Emergency Conditions Waiver in fiscal year 2018, which guaranteed the schools would be funded at their pre-wildfire full-time equivalent student enrollment for FY18 to FY20, as opposed to actual enrollment. Historically, the state of California has held harmless the state aid for any loss in attendance for which funding was based due to wildfire dislocation.

The state of California also backfilled lost property tax revenues in FY18 and FY19 from wildfires, mudslides and other natural disasters, and instituted hold harmless provisions allowing local education agencies to recoup revenue losses from declines in average daily attendance directly related to such natural disasters.

WHAT HAPPENS AFTER THE FIRES ARE CONTAINED AND ELIMINATED?

On 08 January, President Biden approved a Major Disaster Declaration for California, making federal disaster assistance available to the state of California to supplement recovery efforts in the areas affected by wildfires. The Federal Emergency Management Agency (FEMA) assistance can take the form of grants for temporary housing and home repairs, low-cost loans to cover uninsured property losses, and other assistance to help homeowners rebuild. Importantly, federal funding is also available to state and local governments and certain private nonprofit organizations for recovery efforts. Often these costs are first borne by state and local governments and reimbursed by FEMA over the course of one year or more.

The state and local obligation to clean up efforts is governed by the Stafford Disaster Relief and Emergency Assistance Act, which requires a local match to federal aid efforts that may be up to 25% of recovery costs. However, Congress has the authority to waive or adjust the match, as it did for the 2017 wildfires and the pandemic. In these cases, the federal government assumed a larger burden of covering uninsured recovery costs. Congress may, or may not, opt to waive local contributions for the Los Angeles area wildfires. And private insurers will likely also bear a portion of the cost.

Deployment of recovery funding normally provides both short and long-term economic benefits. Reconstruction efforts bring new jobs in the short term and can improve infrastructure, strengthening the tax base in the long term.

WILL CREDIT QUALITY OF AFFECTED MUNCIPALITIES BE IMPACTED?

The key credit factor that Nuveen considers during natural disasters is potential impact on the assessed values of the property within the affected areas. Importantly, assessed value is the main factor used to calculate the tax levy for repayment of an unlimited tax GO bond.

In California, Proposition 13 decouples actual market value of the properties from their assessed values. Proposition 13 limits property taxes to 1% of assessed value and limits increases in assessed valuation to no more than 2% per year. Depending on how long the properties have been owned, the proposition could limit the potential volatility in property tax revenues since the actual market value of the property is not reflected in the assessed value.

WILL THE CREDIT QUALITY OF OTHER TYPES OF MUNICIPAL BORROWERS BE IMPACTED?

Many credits located within the affected areas – such as universities, hospitals, charter schools and utilities – will be impacted by the disaster. Service disruption will be challenging, as it was during the pandemic. We anticipate these entities will roll out contingency and disaster recovery plans in the coming days and weeks.

Most borrowers maintain not only property insurance, but also business interruption insurance, which is expected to help mitigate losses experienced during this period of disruption. In some cases, these entities will also have access to FEMA funds to help with cleanup and rebuilding. Nuveen's credit team is actively assessing impacts to individual borrowers and staying up to date as events unfold.

HOW WILL THESE DEVASTATED COMMUNITIES REBUILD?

At this time, rebuilding is likely given the high desirability of living in the Los Angeles region. Communities fund recovery costs in many ways. In addition to insurance payments, they may use state funds and/or bridge financing. For example, communities may opt to borrow to fund recovery efforts through short-term debt and retire the obligations with FEMA funding when it is received.

Given the likelihood of rebuilding and new construction, affected properties may even be reassessed at the new (higher) market rate once new construction is completed. This could ultimately result in a higher assessed value of the area in the long term.

One factor to consider with this disaster is that the California insurance market has been struggling recently due to insurers leaving the market. The state has its own property insurance program, called the FAIR Plan. FAIR Plan policies have doubled in the past three years, and some are questioning the financial viability of this program. More details will emerge in the coming days, weeks and months regarding how insurance dynamics fit into the overall recovery picture. We will closely monitor the situation for potential impacts on municipal credit.

CREDIT AND BOND PAYMENT STABILITY IS LARGELY EXPECTED

Strong liquidity, large tax bases and historical support from FEMA help mitigate credit impact from wildfires. Municipalities with strong liquidity provide a cushion to deal with the immediate effect before state and federal aid reimbursements are received. Additionally, cities such as Los Angeles with large tax bases have historically held up well versus smaller, more limited tax bases.

When local governments have access to liquidity and large tax bases, it can benefit credit quality conditions. Generally, local governments have good liquidity to help manage short-term emergency costs in the period after the destruction and before the state or federal aid kicks in. Complete or partial destruction of taxable property caused by wildfires could reduce assessed valuations of taxable property within the district. Any reductions could result in an increase in the annual tax rate levied by the county to pay the debt service on the bonds.

Only time will tell how these wildfires may affect these communities, but strong financial reserves, aid from the state and federal governments and private insurance will likely help alleviate some of the impacts and costs related to rebuilding.

For more information, please visit us at nuveen.com.

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