### Credit and environmental risk: is there a link?

Event with no name, J.P. Morgan

Daniel Ingram, Manager, BT Pension Scheme

London, March 19th

**BT** Pension Scheme



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### Introduction to BT Pension Scheme

**Our Trustees** have fiduciary responsibilities to consider long-term factors, including **Environmental** risk, to help maximise the long-term risk adjusted returns required to meet the Scheme's liabilities

- Largest corporate DB pension scheme in the UK at £36bn
- BT plc has business focus on sustainability
- 100% of investment management is external
- UN-PRI founder member
- Long-term, universal asset owner committed to active stewardship

For more background information please visit www.btps.co.uk



### Why do pension schemes value the environment?

#### **Economic and social cost**

- In 2008 global environmental damage caused by human activity: \$6.6 trillion (11% of global GDP)\*
- Of which top 3000 companies contributed over \$2 trillion...
  - ... representing nearly 7% of combined revenues...
  - ... and around 1/3 of combined profits
- 2050 estimated damage: almost \$30 trillion (18% projected GDP)

#### Impacts on corporate earnings and business models

- Puma looked at environmental impacts across the supply chain: water use, GHGs, land use, other air pollution and waste across the supply chain
- The total cost: €145 million\*\*... on €202 million earrings ... or 72% of profits

EUR million	Water use	GHGs	use	Other air pollution			% of total
		33%	25%		2%	100%	
TOTAL	47	47	37	11	3	145	100%



\* UNEP FI, UN PRI, Trucost, 2010

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\*\* Puma, 2011

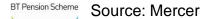
# Unmanaged environmental risk will have a negative impact on our portfolio in long-term

- Understanding of environmental risk historically focussed on public equities
- As corporate bond holders we are mainly concerned about downside risk from:
  - 1. credit spread risk, i.e. risk associated with the company's ability to pay their debt
  - 2. default risk (recovery values)
- Bauer and Hann study found
  - 1. environmental concerns are associated with a higher cost of debt financing and lower credit ratings
  - 2. proactive environmental practices are associated with lower cost of debt



## Our portfolio is sensitive to some climate scenarios

Scenario	Description	Carbon cost in 2030	Technology	Global fixed income	Emerging market debt	Investment grade credit
Regional Divergence (Most likely)	Each country/region develops their own rules and regulations, greatly increasing compliance costs for companies and reducing liquidity	\$110/tCO2e in key economies	Dispersed investment In low-carbon technology; leaders: China, EU			
Delayed Action (2 <sup>nd</sup> most likely)	Little change in emissions practices until 2020, when countries rush to meet 2030 targets	\$15/tCO2e through 2020, then quickly climbs to \$220/tCO2e	Low investment until 2020			
Stern Action (significantly less likely than delayed action)	National and regional ETS' combine to form global trading scheme; Carbon prices and regulations increase gradually	\$110/tCO2e globally	High investment in low carbon technology			
Climate Breakdown (least likely)	No further action is taken regarding carbon markets	\$15/tCO2e in EU and wherever there is an ETS	Increased risk for investment in low carbon technology			



What can we do to manage environmental risk in our credit portfolio?

- Encourage our investment managers to systematically integrate environmental factors into their investment processes
  - Due diligence questionnaire
  - Mandates
  - Reporting
  - Monitoring

 Engage issuers on their environmental performance – early days



# Integrate environmental factors into investment process

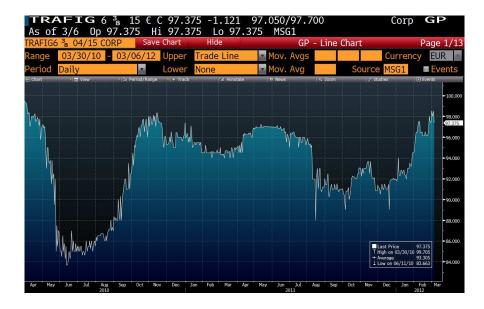
#### Case study 1

- A major oil and commodity trader issued €400mm bond in March at attractive levels.
- Despite obvious value, manager passed on the deal due to lack of comfort with environmental record.
- Bonds issued at par, now trade in 90/92 context with poor liquidity

#### Case study 2\*

- 30 year US municipal bonds
- Unpriced water supply risks

\*See Ceres, 2010





# Engage issuers on their environmental performance

- Where issuer is listed, we should engage on equity and bond holdings together
- Need to manage conflicts e.g. distressed voting although problem mostly at agent level
- Transparency/registry of debt holders- ABI etc
- Rating agencies are key
- Market best practice is currently being developed e.g. UN PRI working group on bonds

