Credit and environmental risk: is there a link?

Event with no name, J.P. Morgan

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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	Land use	Other air pollution	Waste	TOTAL	% of total
	33%	33%	25%	7%	2%	100%	
TOTAL	**47**	**47**	**37**	**11**	**3**	**145**	100%

* UNEP FI, UN PRI, Trucost, 2010

** 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 **(2nd 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			

Source: Mercer

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

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

2. 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