RPIA

Putting the 'G' Back in ESG

The Importance of ESG Engagement by Fixed Income Investors

Authors

Stevie Krohn
ESG Specialist

Vivian Zhao
Credit Analyst

The Fall of an ESG Darling

The recent failure of California-based Silicon Valley Bank (SVB) was the largest US banking failure (by assets) since the 2008 financial crisis.[1] Prior to its collapse, SVB was a darling for ESG fund managers. Close to 1,000 funds registered under EU regulations as either promoting ESG or declaring it as their objective were negatively exposed when the bank failed, either directly or indirectly.[2] The material governance-related risks that resulted in the bank's downfall went unchecked by many ESG investors, and serves as a reminder of the importance of remembering the 'G' when it comes to holistic environmental, social, and governance (ESG) analysis.

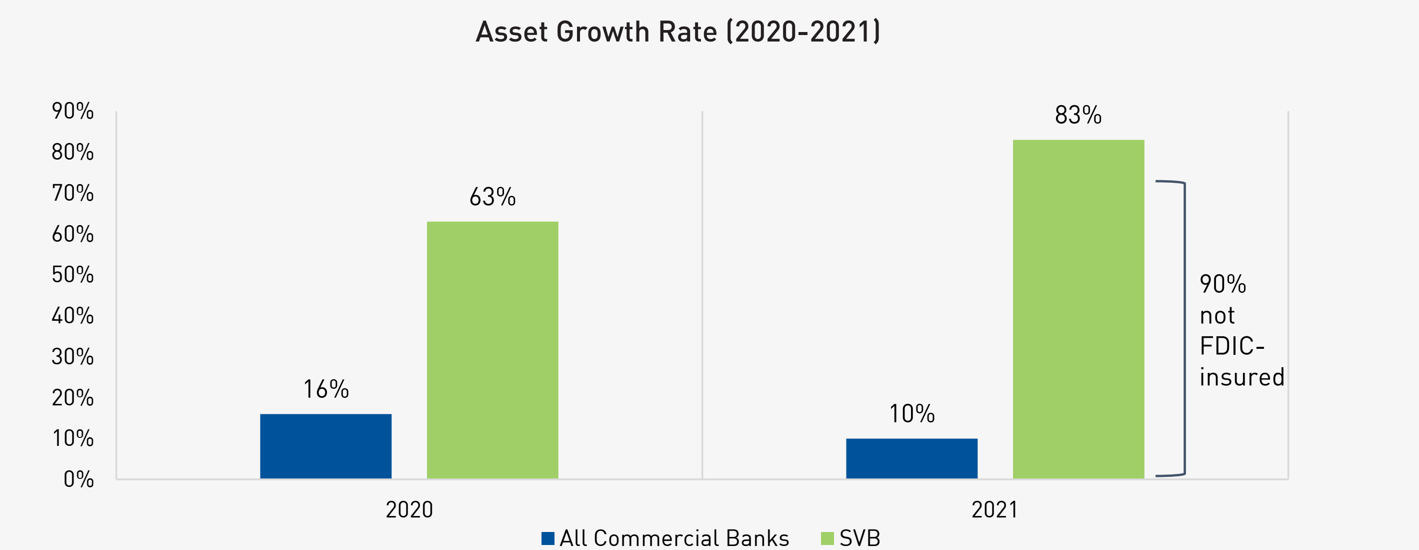
SVB ticked many boxes appealing to ESG-branded investors, including a loan portfolio heavily weighted in renewable energy companies and a low carbon footprint.[2] However, key governance considerations around loan portfolio concentration and liquidity management, risk sensitivity to rising interest rates, and regulatory oversight risk, flew under the radar.

Overexposure to the Tech Sector

SVB had a heavy concentration in the tech sector, making it susceptible to fluctuations in the industry. The bank's overexposure to high-growth, high-risk startups increased its vulnerability to economic shocks that impacted the tech sector.

Rapid Expansion

SVB experienced rapid growth in the years leading up to its downfall, resulting in a significant increase in its total assets. Deposits skyrocketed during the pandemic due to a booming tech startup sector, but a shocking 90% of the deposits surpassed the maximum $250,000 the FDIC insures.[3] This aggressive expansion should have raised questions about the stickiness of deposits, the quality of its loan portfolio, the sharp increase in holding long-term Treasury bonds, and whether adequate risk management practices were in place.[4]



Source: St. Louis Fed, Y Charts

Declining Capital Adequacy Ratios

SVB's capital adequacy ratios began to decline prior to its downfall, indicating a weakened capital position. These deteriorating ratios suggested the bank may not have had enough capital reserves to absorb potential losses from its risk exposures.[4]

Warnings from Regulators

Regulators had expressed concerns about SVB's risk management practices and its overexposure to the tech sector. Despite these warnings, the bank continued its aggressive growth strategy, further exacerbating its risk profile.

Materiality of ESG Factors

There is an increasing body of literature demonstrating the link between better management of ESG criteria and better management of risk overall.[4] Bond investors are also becoming more informed regarding the relationship between ESG performance and investment returns as disclosure increases in volume and quantity. Factors such as carbon-heavy business practices, labor conflicts, and fraud are among the many considerations that can lead to credit risks for bondholders through impacts to cash flow, capital expenses, regulatory scrutiny, and reputation.[5] Although default is an extreme outcome, other risks like credit rating downgrades and related spread widening can negatively influence investor returns in the short term.

ESG integration in credit analysis is not only relevant in the context of risks, but also to inform and identify opportunities. Improving credit stories or the differentiation of bonds with similar financial profiles are just a couple of ways ESG analysis aids in identifying investment opportunities.

Research continues to show that issuers with strong corporate governance benefit from higher credit ratings and a lower cost of capital.[6]

Bondholder Influence Continues to Grow

By integrating ESG factors into analysis, asset managers can better identify and assess potential risks and opportunities, ultimately leading to more informed decisions and better risk-adjusted returns for clients. Consequently, the fiduciary duty of fixed income asset managers extends to a thorough evaluation of ESG considerations, ensuring that they are effectively managing and addressing the potential financial implications of ESG factors on their clients' portfolios.
As relevant disclosure and reporting becomes more consistent and comparable, the industry's understanding of the materiality of ESG considerations on credit continues to deepen and bondholders' opportunities to impact change through investment decisions and engagement continue to increase.

While bondholders do not have voting rights, their potential ability to influence issuer behaviour is indicated by the size of the market. As of Fall 2021, the fixed income universe totaled approximately $128.3 trillion USD, compared to the equity market at approximately $34.8 trillion USD.[7] In exercising their right to choose to support or withdraw from issues that do not meet their standards, bondholders can directly impact cost of borrowing. However, while withdrawing support expresses a negative ESG view, it does not necessarily lead to the change possible through active engagement and meaningful dialogue during and between issuance, either as a single entity or as part of an industry collective.

Engagement with different types of issuers has unique challenges and opportunities based on factors such as disclosure, entity resources, and position on the entity's unique ESG journey.

	Investment Grade	High Yield	Public	Private
Considerations	IG issuers typically have more robust disclosure, greater internal resources, and investors subsequently tend to have more availability of important data.	When analyzing HY issuers there may be a lack of disclosure or third-party data.	Similar to IG, public companies likely have better disclosure and may have more demanding regulatory oversight.	Private companies likely have less disclosure or coverage by third party data providers.
Opportunity for Impact	Engagement can be used to challenge them to utilize their greater resources effectively and strengthen ambitions to produce maximum impact.	Engagement is critical for gaining the necessary insight into the firm to understand their ESG process and identify and assess any material opportunities or concerns.	Engagement can be used to gain insight regarding potential material risks but also encourage bolder ambition.	Engagement can be used to encourage ambition and goal setting but is critical to gain the necessary insights to determine potential material ESG related risks.

Our Engagement Philosophy

As described in our ESG policy, we apply our ESG integration process across all strategies. We score issuers using quantitative metrics, conduct in-depth subjective credit research on holdings and practice active issuer engagement, where we discuss and challenge issuers on ESG-related disclosures and business strategy. We then use these assessments to inform how we price risk across the portfolios. Over time, we have found that ESG-related analysis often informs other areas of our research and vice-versa. To this end, our Portfolio Management team is responsible for integrating ESG analysis into their process, whether through in-depth research or portfolio structuring.

Our channels of communication include individual updates from senior management teams to discuss business results and outlooks, catalyst-driven conversations with management teams as part of a transaction and contributing to industry-driven comment letters and discussions where appropriate. In addition, we are in regular discussion with companies and syndicate desks of the underwriting banks regarding new issue transactions. We believe active engagement is an integral component of our responsible investment approach.

Engagement Case Study: Blue Owl

Background

In Q1 of 2023, we met with Blue Owl ("OWL"), a US alternative investment asset manager with three main operating lines of business. As a result of having a decentralized legal entity structure and a centralized operating model, its legal structure poses challenges related to providing full transparency into the ESG risk and exposures of its subsidiaries' underlying funds. One of its three main lines of business is being the manager to a number of Business Development Companies ("BDCs") under its OwlRock brand, many of which have issued bonds publicly in addition to the bonds issued by the ultimate parent company, OWL.

Engagement Focus

We held two meetings with the company, one in December 2022 and another in January 2023 with additional members of the management team. Our conversations focused on the issuer's reporting and product governance, particularly:

- Disclosure of ESG risks and exposures of investments held by entities lower in OWL's legal structure.
- Robustness of their sustainability reporting (ambitions regarding CSR, etc.) and alignment with regulatory (e.g., SEC) and voluntary sustainability reporting frameworks (e.g., TCFD, SASB, GRI).

As a public company, OWL will be required to comply with the impending new SEC rules for sustainability reporting. In early 2022, they hired a Head of ESG to address current gaps in reporting and disclosure.

Progress & Monitoring

We requested the meetings with OWL after our fundamental research team identified insufficient reporting on the ESG risks and exposures of both OWL and its subsidiaries. While OWL and their asset manager peer group all face legitimate challenges with regards to ESG risk reporting, we would like to encourage OWL to act as an industry leader and take initiative to not only incorporate ESG within their underwriting and investment processes, but to also track and report ESG data, including GHG emissions, both for the parent company entity as well as the BDCs that issue debt. We believe that not doing so could be deemed a risk related to their product governance practices, although we acknowledge the challenges with producing such reporting.

In hiring the Head of ESG and developing a concrete plan with visible improvement since early 2022, Blue Owl and its subsidiaries are making sustained progress. We are encouraged by their willingness to discuss and receive feedback from debt investors. The company acknowledges that it still has progress to make; however, we look forward to the ongoing engagement discussions, as well as continuing to monitor their reporting and investment practices, including the targeted publication of their inaugural Sustainability Report in 2023.

Recommendations

We provided several points of feedback to Blue Owl on our recent calls. We would like to see the company doing the following:

- Acting as a leader in the alternative asset manager and BDC sectors, specifically having more clarity on the measurement of its climate impact (Scopes 1, 2, and 3).
- Setting meaningful emissions reduction targets or a net-zero plan and beginning to see demonstrable execution of any plan.
- Creating an ESG Governance Framework and forming a dedicated ESG research team and an ESG committee to strengthen the company's ESG framework and governance.
- Expanding commitments to the social pillar, building on the Blue Owl Community Loan Program.
- Eventually considering a green, social, or sustainable bond or sustainability-linked bond issuance.

We have already followed up with OWL since the second meeting, sending them specific requests for data that we would like to see included in their reporting in future periods.

In addition, we discussed the specific criteria for exclusion from the RPIA Fossil Fuel Exclusion (FFE) strategies and requested information on whether there are any precluded activities at the subsidiary levels that cannot be identified in BDC company disclosures.

We intend to hold another meeting with management in due course to receive feedback on our discussion and forwarded materials and questions.

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Important Information

RPIA

43 Hazelton Ave.
Toronto, ON
M5R 2E3

www.rpia.ca
General Line: +1 647 776 1777
Investor Services: +1 647 776 2566