TRANSCRIPT

Bribery – Where ESG Risk and Externality Collide

Featuring:

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Bentley Kaplan:

Hello and welcome to the weekly edition of ESG Now, the show that explores how the environment, our society and corporate governance affects and are affected by our economy. I'm Bentley Kaplan, your host for this episode. On today's show, we are going to cover two stories. First, we're going to talk to Sam Block about the 276 million pounds that Glencore was ordered to pay over historic bribery activity in five African countries over oil access. And then, while some of my colleagues, and no doubt, some of our listeners are in the bustling fray of COP27 in Sharm el-Sheikh, we'll talk to Cody Dong about the insurance industry, and specifically how to understand its future climate risks. Thanks for sticking around. Let's do this.

Briefcases full of hard cash being flown in private jets across Africa, bribes listed as office expenses, a cash desk dispensing dough and a lightly disguised code word, like chocolate. These are just some of the details that emerge from a probe by the UK's Serious Fraud Office into the activities of Glencore, a multinational commodity trader and mining company. Now after these investigations, Glencore Energy UK pled guilty to seven counts of bribery between 2011 and 2016, including in Nigeria, Cameroon and South Sudan. On the 3rd of November, a London judge ordered the company to pay more than 276 million pounds, which was a combination of a fine and order, and that total cost equates to around 13% of the company's revenue last year.

In total, the company's West Africa desk is estimated to have paid more than $28 million in bribes, and the judge reckoned that Glencore benefited from this bribery to the value of just under 94 million pounds, which is around $180 million. In taking this news and trying to make ESG sense out of it for a multi-billion dollar company like Glencore, well, it can be hard to find the best place to start. So we're going to take an approach that we have been highlighting in our past three episodes by considering the company from a couple of different angles. If you want to get little further into these angles, please do browse our past episodes on Tesla, on the ESG of medicine and chocolate, and my personal favorite, the one Mike hosted called Everyone Hates ESG. But in the case of Glencore, we're going to look specifically at how ESG factors can create financial risks for a company and also what the company's actions or products mean for society and the environment, its so called externalities. To help me break these pieces up, I called Sam Block, one of our more well-seasoned industry analysts.

Sam Block:

It's a company which has a really complex character. People that want a simple story about it probably either think of Glencore as this powerful trading house with a major industrial complex backing it, or they think of it as a company with just full of controversies, like briberies. Some of the complexity about this company is really due to its willingness to take on risks and to go into challenging places that many other companies would avoid.

Bentley Kaplan:

Right, so for us at MSCI ESG Research, understanding financially relevant ESG risks for a company relates very strongly to what business its involved in and where its running its operations or making its sales. Glencore and its proponents might easily point to the difficulty of operating in countries where bribery is part and parcel of conducting business, where basic market access is almost predicated on your willingness to pay bribes or facilitation fees. But this nuance doesn't always lessen the risk for a company. As Sam tells us, because Glencore has been willing to set up operations in areas with high levels of conflict or instability or corruption, it also means that these types of factors can ultimately find their way into the company's bottom line.

In this particular example of the court's findings of bribery allegations, Glencore was sustaining both reputational impacts, which may make contracts a little harder to come by, and a fairly hefty fine. But we also try to understand how well a company is managing its ESG related risks through the strength of its management programs or oversights. Better management of risk theoretically means that a company will have a lower chance of seeing ESG factors have a negative outcome for them. It's clear that between 2011 and 2016, there were some gaps in Glencore's anti-corruption oversights, but Sam, and likely Glencore's investors too, will be watching the company moving forward because Glencore announced an overhaul of much of its compliance framework and they set up more extensive and robust oversight and dramatically narrowed the role of third parties in contracting. And having these measures in place might help the company reduce its chances of being tripped up by these scandals in future.

But as I talk about how Glencore's bribery creates risks for its reputation and bottom line, I know some listeners, and maybe you're one of them, will be seeing the story from the opposite angle, not about a company that suffers the consequences of its own bribery activity, rather the consequences of the company's bribery for the society around it. Because a company is not just something that has things happened to it, like market related corruption risks, a company is an active participant in whatever market it happens to be in. It's out there in the world, creating impacts both positive and negative for both society and the environment, capital S, capital E. For something like corruption, while Glencore is paying its fine and confiscation order, countries are looking at different issues. According to the UN office on drugs and crime, enabling corruption through things like bribery means economic loss and reduced efficiency, but also more inequality, dysfunctional public sectors, organized crime and the list goes on.

And this duality is true of many ESG risks for companies. Limiting carbon emissions means lower compliance related costs for a company, sure, but also a positive contribution to climate change mitigation. A good employee benefit package means that a company can retain talent, but also that employees enjoy a better quality of life or a better work-life balance. Ultimately staying on top of a financially relevant ESG risk can mean that a company takes care of its own bottom line, but it can also mean less negative impacts on the people and environment around it. Or put another way, failing to manage a company's own risks can also have negative consequences for those around it. And one way we assess that external impact at MSCI ESG Research is through our ESG controversies data.

Sam Block:

The controversy we rate as the most severe for this company is actually related to a thermal coal mine in Northern Columbia. It's the largest open pit thermal coal exporting mine in the world, its land footprint covers something like 270 square miles, and beyond the obvious implications of climate change, we've actually assessed it as facing a very severe controversy because of the impacts to the local indigenous population. A UN report from 2014 stated that people subsist on less than a liter of water a day on average, while we've also seen reports that says that the mine extracts like 2.7 million liters per day. The allegations against the company got worse when almost a decade ago during an expansion of the mine, it had to redirect a stream, a tributary, to one of the major rivers in the region, which may have also had an impact on the fragile nature of the water resources in the region.

Bentley Kaplan:

So Sam also went on to tell me that this controversy has a lot of different moving pieces. Multiple court cases are still ongoing and unrelated to the mines operations, a severe drought has been impacting the region for several years. In addition, Glencore has reported improvements to its water management practices and also has said that the impacts of the mine on local water resources has been overstated. More broadly though, the company's external impacts are not limited to this thermal coal mine in Northern Columbia. We also recorded cases linked to safety, environmental contamination and community conflicts across multiple sites in the Americas, Africa and Australia.

And even though some of these incidents happened years ago, the total lifetime of a mine can span several decades. And so you have this long term lock in between a mine and both the environment and communities that live around it where impacts from the mine can continue to blow back on the mine owners in the shape of protests or lawsuits over many years. But the story doesn't end there. Glencore is not just a company that operates in regions where the line between market access and corruption can be a bit blurry, or just a company that runs huge mines and calls for the management of long-term relationships with communities, NGOs and other stakeholders. Because as Sam told me, the company also has the potential to drive positive impacts further down the value chain.

Sam Block:

Its coal product line is worth about 9% of its overall revenue, which has grown over the years, but still remains a small component overall, and what we actually see is that a lot of the rest of its product mix is actually fill of what we call kind of the climate forward metals such as cobalt, copper, nickel, lithium. I like to consider these metals as part of a balanced breakfast for sustainable development. Glencore is the largest cobalt producer in the world, the third largest copper producer in the world, second largest nickel producer in the world, and all of these metals are going to be in high demand for kind of the low carbon futures, for things like renewable batteries or a build out of electrical infrastructure.

Bentley Kaplan:

Right, so Glencore is holding a few cards up its sleeve for the low carbon transition. Coal may one of its revenue streams, one tied to growing emissions, but with interest in metals that are critical to development of batteries and other lower emission technologies, a low carbon economy might hold some serious potential, which leaves investors with a few questions to answer. It certainly can be helpful to think through a company in different ESG angles, whether you're talking about the company's financial risks or its external impacts, or even the role it might play in a low carbon transition. But at some point, ESG data and ratings and assessments will hand over to investment philosophies and mandates. The hardest decisions might not be in deciding whether ESG data offers an investment signal, but deciding which component of this data best aligns with your mandate.

If you're working through headlines at the same time as I'm recording this and you can somehow get through the staggeringly complex election forecast models that are draped over the US midterm elections and the blow by low coverage of Twitter sale to Elon Musk, then you might have spotted a few stories coming out of Egypt as part of COP27. A few of my colleagues are right in the thick of it and we'll do our best to get some perspectives from them in our show next week. But in a nod to the discussions, sidebars and plenaries that are peppering the conference rooms in Sharm el-Sheikh, our next story is going to focus on climate risks, climate risks in the sense of how climate change might impact on a company's future value. Because, while hugely important pledges are being made and deals being struck between national governments, some degree of future climate change appears unavoidable, even if its severity is yet to be determined. And knowing what types of risks a company faces is one question many investors are naturally looking to answer.

What's worth noting here is that every industry is looking at these climate change risks in different ways, and in ways that are not always as obvious as an oil and gas company having to reckon with the risk of stranded assets if the world collectively and suddenly decides it's not buying oil anymore. Let's take insurance for example. You know, insurance, those monthly deductions you see in your bank account, those deductions that may give you a twinge of resentment as you are working from home means that your car is now parked off street most of the time. Or even a counterintuitive resentment because every time you walk out of your front door, your house remains unbashed by a falling tree, even though you're paying every month to be insured against this unlikely, but awful event. But putting aside complex feelings about insurance for a moment, let's acknowledge that insurance companies have a pretty unique challenge figuring out the likelihoods of a nearly infinite range of circumstances, then which of those they can ensure against and then how to price their premiums wisely or risk losing market access to a less risk adverse competitor.

And then, once you've done all of these incredibly complex calculations, well, things can change, right? The risks of different activities and different assets shift over time. The likelihood of being in a car crash today versus a hundred years ago is obviously very different and insurers have to adapt to these changes. In one area, you can probably sense that we're heading for here is climate change, and insurers know it too, and it's not hard to figure out why. Check the headlines on a weekly basis and you'll see stories of hurricanes, flooding, heat waves and wildfires. These events pose risks for both property and people, and these are just event based risks. But climate change also means baselines will move like average temperatures, which itself has knock on consequences for health and mortality, both things that insurance companies cover. To give a sense of how insurance companies have to grapple with climate change, I brought in Cody Dong out of our Shanghai office.

Cody Dong:

Climate risks can affect both underwriting and investments. Underwriting the most property insurance they price their policies every year. In that sense, they can quickly adapt to short term changes of risks. But I wouldn't say that is not important for property insurance to manage climate risks because climate change can alter the long term attractiveness of certain risk markets. Insurance might want to get out of certain markets because it becomes too risky to ensure.

Bentley Kaplan:

Right, so as Cody tells it, insurers are underwriting risk and they're thinking about the implications of climate change, quite crudely, at two time scales. One is shorter term, which means adjusting premiums say on a yearly basis to reflect changes in risk. But then they're also thinking on a longer time horizon because small changes in risk from year to year roll up into bigger changes, changes that make some assets or regions difficult to ensure, either because the risk is too unpredictable or where the risk just becomes too high for an insurance product to work, think something like rising sea level and beachfront properties. And at this longer time scale, insurers may opt to withdraw their products from certain clients or markets or simply have no choice but to offer products with premiums that effectively prices out a big chunk of potential clients, who in some cases most desperately need that specific insurance. But as Cody gave more industry context, it became clear that insurance companies don't only have the underwriting risks to consider.

Cody Dong:

A big profit engine for insurance companies is their investment return and insurers' investment portfolio is a main area where climate change may pose a threat. For investments, value can be destroyed due to investing companies assets being damaged by extreme weathers, investing companies paying higher carbon tax. On the other hand, investing companies that have more green revenue, more low carbon patents may grow rapidly in the future. So there are different components at play.

Bentley Kaplan:

Right, so insurers have to figure out the risk of insuring all of these different things, your house, your car, even you. But at the same time it's running these complicated risk models, the company is taking in premiums from you and the other clients, sometimes numbering over a hundred million people for the world's largest insurers.

And this huge pile of premiums is one big avenue of future climate risk because these premiums have to be invested somewhere, in bonds, in equity and other more complicated instruments. And all of these investment types, well, they all carry different levels of future climate risk. And in their investment portfolios, much like those of other asset managers or asset owners, insurers could see upsides or downsides from their investments through things like changes in climate related policy, think carbon taxes, physical climate risk, think flooding of seaside high rises, something that has a quirky overlap with an underwriting business and technology opportunities, like the sale of wind turbines.

And so insurers, while they may have an army of actuaries actively navigating the changing risk landscape for the underwriting business at the same time have to be monitoring the way that climate change is going to ripple through into their portfolios for net gains or net losses. And I'll spare you a long winded explanation of our methodology here, how we can project those net gains and losses through our climate value at risk model, because I think in fairness, we've subjected you to enough of our methodology over the last couple of episodes. Plus, you'll need to be very comfortable in your listening chair if you're wanting to follow all of the developments at COP27, and I don't want to get in the way of that. But as you do tune in and read the many commitments and pledges that are bound to follow, I hope this industry example will bring to light some of the ways that climate change might materialize and further highlight the imperative of slowing its trajectory.

And that brings us to the close of this week's episode. For Sam, Glencore remains a complex company, even approached through different ESG angles, but a great example of how the concepts of financially relevant ESG risks like bribery, water intensive operations can dovetail with social and environmental externalities. And for Cody, looking at the insurance industry through the lens of climate related risks shows an interesting risk profile, one that involves not only complicated calculations around risk, but also knowing how future climate change might impact an investment portfolio. And that is it for the week. A massive thanks to Sam and Cody for their take on the news with an ESG twist. Thanks as always, to our listeners for tuning in. Don't forget to rate the show, review us on whatever platform you happen to be listening on, all and any feedback is great, so please do keep it coming. And I know you keep missing him, Mike will be back with us in a few weeks' time, so in the meantime, stay safe and I'll be back again with you next week.

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