

# It's Scorching in Seattle and Overdraft Fees are SO 2020

*Featuring:*

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Bentley Kaplan:

Hello and welcome to the weekly edition of ESG Now, where we cover how the environment, our society and corporate governance, effects and are effected by our economy. I'm Bentley Kaplan, your neighborly host for this episode. On today's show, we're going to start where it's hot. And right now that is in the Northwestern United States and Western Canada, where residents, government officials and health care workers negotiate a vicious heat wave. As scientists dig into the links between this heat wave and climate change. We'll take a look at an industry under increasing pressure for its role in exacerbating climate change, oil pipelines, crisscrossing the North American landscape. And for these pipeline companies, risks from a new and growing investor interest in climate is being interwoven with a much older risk.

You see for decades communities and indigenous peoples have had to contend with pipelines accidentally spilling oil into their local ecosystems and water supplies. And even though these communities have long protested at the presence of pipelines, their plight is starting to gain more attention. As activists successfully leverage global interest in climate change. And the record-breaking heat bubble is a timely reminder for investors who may be squinting into the long-term future of pipelines and weighing up not only climate change, but impacts on communities and biodiversity, along thousands of miles of pipeline network. And from heat, bubbles and pipelines we'll make a hard turn into the financial world for our second story, to take a look into the decision by US-based Ally bank, to scrap overdraft fees for all customers. And as the behemoths of the American banking world, Chase, Citibank, Bank of America, and Wells Fargo look said to keep the overdraft fees in place. We'll try to figure out whether there is more to this announcement than just a marketing boost for Ally.

Thanks for sticking around. Let's do this...

Just as parts of the U.S. and Canada, look to be turning the corner and leaving behind the worst of the COVID-19 pandemic, an area of high pressure or a heat dome started forming over a northwestern section of North America, which started compounding on itself. That's led to high temperatures, temperatures so high that they are breaking all-time records. Day after day, people have died. Businesses and schools have closed. And in temperate regions unprepared for these conditions. Governments are providing cooling centers as refuge for residents, and the role of climate change in driving this type of event is complex, but there

appears to be consensus that anthropogenic climate change is making these heat waves more frequent, longer and hotter. And for every climate related disaster that pops on the news from heat waves in North America to Bush fires in Australia or floods in the United Kingdom, pressure is ramping up on asset managers and asset owners to take action, to adapt their investment strategies, to navigate not only policy risks, but to drive change towards low carbon economies.

One set of companies under the microscope of many would be those in the oil and gas industry that have midstream operations, basically meaning companies that process store transport and market oil and gas. The most iconic of which even if just for their sheer engineering hubris would be companies operating gas or oil pipelines. And for those investors fretting over their portfolios, three colleagues of mine at MSCI ESG research, Chris Cote, Antonios Panagiotopoulos, and Kevin Kwok put together some pretty timely research in their paper Under pressure, climate biodiversity and community relations risks for North America's major oil pipelines kind of says it all for you. So I called up a couple of the authors to try and get their take on whether something like a heat wave can ripple through to an industry that runs thousands of miles of oil and gas field pipelines across the U.S. and Canada. Antonios was the first to lay the stage for me.

Antonios Panagiotopoulos:

So in the North American pipeline segment, we do have independent operators, companies that are focused just on the construction and operation of the pipeline segment. These essentially need to bridge supply and demand between exploration and production, where they produce oil and gas, run it through their pipeline by capacity contract, and then deliver that crude oil to refineries, which represent the downstream demand for oil and gas. Now pipelines that carry crude oil from Western Canada specifically, have faced significant opposition because of the oil that they carry. Canadian tar sands have a higher carbon intensity, both to produce, but also to consume. So therefore, some of the recent opposition that we have seen have had the preface, of oil sands in the sense that they are covering a higher carbon intensity crude.

Bentley Kaplan:

Okay, so there's a start. Pipelines, move oil, but not all oil or gas is equal. Oil that comes from Canada's tar sands needs carbon intensive processes to get it out in the first place and to actually use it to generate energy. And one of the lightning rods for debate about oil from Canadian tar sands was the Keystone XL pipeline planned by the Canadian company, TC Energy. Although, part of the pipeline has already been completed, a critical 1200 miles section was intended to run from Alberta through Montana, South Dakota and Nebraska, but ultimately the project was canceled in early June 2021, following the U.S. President's decision to deny a key permit for the project on a busy first day in office, way back on the 20th of January. So that seems like a big deal. There were those that may saw this as a clean, swift end to oil pipelines, at least new ones.

But things in life are a little more complicated than that. Because another contested project, plans by the Canadian company, Enbridge to build a 340-mile section of pipeline across Northern Minnesota as part of an extension of its line three has not been opposed by the Biden administration as of the time of recording.

So, I asked Antonios what he thought about the lifespan of the oil pipeline business, when the regulatory environment looks to be in this type of flux.

Antonios Panagiotopoulos:

We do see some ongoing issues, hurdles in the short term for North American pipelines. One of the early actions of the Biden administration was to pause new oil and gas leasing, which could reduce oil production over the long-term. At the moment, those leases are based on a long-term schedule. Now, if we want to look at it from a wider perspective in the near term, and based on the current levels, we don't see an impact specifically from carbon taxes, be that either in Canada or in the United States for impacting the construction or even the ongoing operation of those pipelines.

Bentley Kaplan:

Okay. So pipelines are on a slow moving timeline. They work on long-term contracts to transport oil, agreed to well in advance five, 10, or even 15 years ahead of time. And even though the U.S. and Canada are making more progressive moves on climate change legislation, Antonios, doesn't see that carrying forward into short-term impact like a sudden carbon tax or regulations to terminate ongoing pipeline operations.

And at this point it's tempting to think of pipelines as just a link in the value chain. Only subject to what's happening on either end. If energy, you start slowly turning away from fossil fuels and towards renewable energy, they might see a gradual drop in demand from downstream clients, or if upstream producers find it harder to get approval of permits for new exploration projects, then the volume of oil available to transport might start slowing or be it gradually. But then, Antonios reminded me that pipelines are not just a conceptual link in the oil and gas value chain, but hulking steel pipelines, channeling millions of barrels of oil every day, across thousands of miles. And it's at localized spots across these thousands of miles that our story comes to a head.

Antonios Panagiotopoulos:

Pipelines are the safest and most efficient, economical way to transport oil, especially in the context of North America. However, even the impact of a single spill can have severe negative impact on the surrounding environment. But also the nearby communities may create adverse reputation and financial risks for the companies involved. The management or mismanagement of relations with community groups and especially indigenous groups, we have seen from other industries, but increasingly in the pipeline industry as well, that it may lead to the permanent loss of license to operate. As with the Dakota access pipeline a few

years back. And in 2021 with the TC Energy Keystone XL when these projects gain an international spotlight, some risks may grow to such extent that are impossible to manage.

Bentley Kaplan:

Right so, as Antonios explains, pipelines are really safe and efficient, relative to other ways of transporting oil and gas. But one misstep is hugely impactful. A single spill can have contaminated surroundings with thousands of barrels of oil. Communities, opposed to pipelines aren't just objecting to their presence running through their land, but to what could happen if or when something goes wrong. And there's nothing particularly new about pipelines accidentally spilling oil. If you search the internet for oil spill events from pipelines, you'll see them peppered across the past several decades. And it was way back in 1991, when the worst spill in U.S. History happened on Enbridge's line three, when 1.7 million gallons of crude oil spilled into a wetland and a river near the grand rapids in Minnesota. But what is shifting is how localized protests against pipelines are starting to leverage regulatory and invest interest in climate change to draw attention to their causes.

But the prime examples being the Dakota access pipeline and Keystone XL that Antonios mentioned earlier. And it's difficult to know if investors were already taking an interest in community and indigenous rights and by diversity impact without any climate change angle, but there was something about tying these issues together that is rolling attention up onto a national and international stage to get a sense of how this pressure from current protests might be translating for investors and pipeline companies. They'd usually look out over a 10 or 15 year window. I gave Kevin Kwok, one of Antonio's co-authors on this paper, a quick call. For him, the interesting side of this story is how it could play out for companies and the key source of their funding, fixed income investors.

Kevin Kwok:

Yeah so, it's always been a little bit different for every single part of the energy sector. So traditionally the midstream sector has really been privy to long-term debt horizons. So because of their business models, they've always had long-term contracts, which are tied to producers for transport and storage, and they have a minimum set volume and pricing. So climate risk and biodiversity and community conflicts now are really testing the future long-term debt. And most of what investors are doing now, these are engaging on different levels. You know, even before bonds are launched, investors are basically saying that they will not invest in certain companies. If ESG issues are not transparent or being tackled. And this has put a lot more pressure on issuers these days, because that is the cheapest cost of capital for them in order for them to grow.

Bentley Kaplan:

So even for debt investors that can't vote on shareholder proposals and don't have the same rights as equity investors, there is still space to lean on pipeline companies to push them, to improve their practices, to do a little better. And for Kevin, one way to understand this is through a comparison between MSCI's ESG rating, which tells the difference between ESG

leaders and ESG laggards and a traditional credit rating. Which assesses financial metrics to give you lower risk or investment grade bonds or riskier high yield bonds.

Kevin Kwok:

So when we think about investment grade and high yield investors. So, oftentimes investment grade, we also think of very strong financial metrics, but contrary to what most investors do believe, investment grade companies can struggle to manage their ESG risks. Looking at our analysis, high yield issuers really only accounted for about 4% of the total outstanding debt. And this peer group, none of these high yield issuers were ESG laggards. So there were actually a few ESG laggards in the investment grade side. So as I mentioned, stronger financial metrics, but sometimes they're also bigger, more diverse. Some of these large companies like Enbridge, they have operations all over North America. So they have Canadian operations and also multiple regions all over the U.S. so they have to deal with a lot more different biodiversity issues, climate issues as well as community relations issues.

Bentley Kaplan:

And I know that might've flirted with the wonkier side of the financial universe, but Kevin makes a great point. One that ties this whole story together because as pipeline companies already know. And as many investors are quickly learning, there is a complex environmental and social world out there. And dropping thousands of miles of oil pipeline into that world creates a risk for companies and their investors. And having a great credit rating doesn't tell you all that much about how well a pipeline is managing social and environmental risks along its massive network. Or how likely a company is to suddenly find itself on the wrong end of a protest by local communities or indigenous peoples. Protests like those that surrounded the Dakota access pipeline, Keystone XL, and Enbridge's line three. Protests that connect with policymakers and ones that hold up accelerating climate change, like a record-breaking heat wave across the U.S. And Canada, as a reason to be heard...

And from the baking Northwest. For our next story, we are going to make a hard turn into the welcoming air conditioned officers of the banking world. In June 2021, Ally Bank, which is the largest digital bank in the U.S. made an intriguing announcement. That it was going to end overdraft fees on all accounts. To get down to the ESG roots of this announcement I called up one of the newer members of our ESG research team, out of New York, Carrie Wang.

Carrie Wang:

It's always the heaviest fee, among all sorts of bank fees. The original intention is to discourage overrawing, but in the past 20 years, overdraft fees have actually risen from an average of \$21.57 in 1998 to an average of \$33.47 in 2020.

Bentley Kaplan:

Okay. So the overdraft fee is kind of like a short-term loan. Banks maybe don't want the hassle of lots of people overrawing their accounts. So they slapped them with this overdraft fee.

And I know, it seems like a simple enough idea. Kind of like how a wine tasting charges a token fee to just stop people showing up for free wine, but away from hypothetical wine tastings. In real life and the hard numbers of COVID-19 and growing inequality. How are these overdraft fees impacting on society is a whole other thing.

Carrie Wang:

In 2020, Americans in total paid \$12.4 billion in overdraft fees, which is a relatively large number, but disproportionately hurts low-income and moderate-income people. And also black and Latino families. More than 80% of the overdraft fees are paid by consumers who are living paycheck to paycheck.

Bentley Kaplan:

So overdraft fees in the U.S. are one of the reasons why some people might say it's expensive to be poor. People with less money in their account, still need to buy groceries or pay their rent. And when they overdraw their account, it starts making it more expensive for them to bank, than someone who might never be at risk of using an overdraft facility in the first place.

Which brings us back to Ally Bank and its decision to scrap overdraft fees. Carrie threw some numbers at me. For Ally, a small bank with no physical branches and low overheads, overdraft fees before they were scrapped brought in \$5 million, which equates to 0.07% of total 2020 revenue. Now contrast that with big brother bank, JP Morgan, that cashed in 1.5 billion in overdraft fees, or more than 1% of its total 2020 revenue. And it's because of these numbers that banks are under increasing scrutiny for their overdraft fee policies. In May 2021, Senator Elizabeth Warren criticized the CEOs of JP Morgan, Wells Fargo, Citi, and Bank of America for taking in a collective \$4 billion in overdraft fees during the COVID-19 pandemic. And that's despite those banks having their own overdraft fees waived by the federal reserve. Which politics aside doesn't look great, but I want to scratch just a little deeper. Sure, Ally doesn't depend on overdraft fees and yes, scrapping them might put them under less political pressure and see a nice little PR bump, but it turns out there's a little more to it.

Carrie Wang:

So first off all Ally Bank does market itself as a low-cost banking choice for customers. So the move off eliminating overdraft fees, on all its accounts would definitely provide additional growth opportunities in underserved communities. And those also may be able to attract customers from their competitors. And the last but not least, it would also help bring in business or its investing and lending platforms because they do have other products such as Ally Invest, Ally Mortgage and Ally Car Loan.

Bentley Kaplan:

So Ally bank isn't necessarily dropping overdraft fees as an act of pure kindness. For the currently unbanked or low and middle income earners, the absence of overdraft fees, may be a signal of a bank that's more attuned to their reality. And maybe that won't only win new

customers, but see old customers feeding into the banks related offerings like mortgages or loans.

But of course, that won't be the end of the story for Ally Bank taking on more low-income customers and offering products like mortgages or car loans also means taking on more risk of customers going through financial difficulty or defaulting. And that is bad for any bank, not only financially, but because it invites lots of regulatory scrutiny into its lending practices, education initiatives for customers, and whether its employees were given the right training to handle these complex lending dynamics.

And maybe especially because Ally Bank is taking this first big step, competitors will be watching closely. In times of rising inequality any bank would do well to find the balance between market penetration and risks. And only time will tell whether Ally has been boxing clever. But you can be sure that a savvy ESG investor is paying very close attention...

And that is it for the week. My favorite part about this job is being able to turn a story over, to find the vein of ESG running through it. For the oil pipelines running across North America. Climate changes amplifying the voices of protest and highlighting how a poor environmental or social track record can put pressure on companies that are used to locking in contracts for 10 or 15 years or more. And for Ally Bank, reading the shifting social pressures might mean a short term drop in revenue, but with the potential upside of more customers and more opportunities to serve those that needed most. And for investors, these stories are reminders of how ESG can layer on top of traditional analysis or investment strategies to shine a light on opportunities and risks from a totally different angle.

A massive thanks, to Antonios and Kevin and Carrie for their take on the news with an ESG twist. A special shout out to Chris Cote, he coauthored Kevin and Antonios' paper, and he gave me some great ideas behind the scenes. So Chris, if you're listening, do take a bow. And thank you, our dear and great listeners for tuning in, we love your feedback and questions. Please keep them coming. If you have the chutzpah, don't forget to rate and review us and subscribe to the show. We will be taking a much needed break next week, but Mike will be coming at you the week after that on the 16th of July. Thanks again, and hope that you are finding some respite from the pandemic or the heatwave or any other omen of the end times. Bye for now.

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