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TRANSCRIPT

ESG Now Podcast

The Fed Mulls Climate Risk and Swifties Sue Live Nation.

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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're going to take a look at the recent announcement by the US Federal Reserve, asking the country's biggest banks to figure out how their businesses could be impacted by climate change. We'll walk through what it means practically, why it's important and why this might be part of a bigger sea change for regulation. And after that relatively sober conversation, we'll kick off our work shoes, slip on a pair of high tops, and look at the world through the eyes of a Swifty, which is street talk for a Taylor Swift fan. We're going to see how everything has changed for anyone trying to buy tickets to her concert. Why it's hard to just shake it off, shake it off, and then we'll explain how this is a problem that ESG knows all too well. Thanks for sticking around. Let's do this.

So banks, right? Unless you're actually in the industry, you're probably not sitting on the edge of your chair when I drop the words bank or banking. But whatever your personal feelings are, banks are linchpins of an economy. As conduits of capital, they can be large and complex, and because of their central position, they are regulated pretty heavily. And for US banks, one of their key regulators is the Federal Reserve, the country's central bank. And on the 17th of January, the Fed asked the country's six largest banks to put together data on how they would be impacted by both climate change outcomes, so-called physical risk and a transition to a lower carbon economy. This information would be separate to the mandatory stress tests that banks need to run, which are supposed to figure out if a bank has enough capital to see it through some hypothetical scenarios, things like a big recession or a market crash.

Any US banks with more than 50 billion in assets has stress tests run internally and also by the Fed. And maybe unsurprisingly, these more traditional stress tests became much more commonplace after the 2008 financial crisis. But in terms of climate risks or climate stress tests, this is very much an exploratory phase. Currently, the Fed is only asking for this information from the country's biggest six banks, which are Bank of America, City, Wells Fargo, JP Morgan, Goldman Sachs, and Morgan Stanley. Maybe you've heard of them. These banks are very, very big. Their investments and loans are spread across many different industries and companies and assets.

Although this diversified exposure does mean that banks are in some way protected from a specific risk that materializes in a given industry or sector, like say, a sudden spike in the price of coffee, a risk like climate change is quite a different beast, because climate change is driving a range of different physical impacts with varying intensity and frequency. And as governments and companies respond by either mitigating their climate impact or increasing their resilience, it's resulting in things like a rise

in renewable energy or increasing risk of something like a coal mine becoming a stranded asset. So, to give me a better sense of what these climate risks could look like for banks and how a bank might go about trying to assess these risks, I called up Carrie Wang out of our New York office.

Carrie Wang:

So for banks, they need to assess their exposure to different types of physical hazards, including not only in their own branches, but also the possibility of their customers default if their homes are damaged. They need to assess in different regions what types of physical hazard they're going to face, and what are the potential damages and cost that can be caused by those hazards. As we transition to a lower carbon economy, banks need to assess their exposure to carbon intensive industries. There's definitely challenges banks will face. As we know, like Scope three emissions are kind of difficult to measure, especially for those banks because they have large amounts of indirect emissions coming from their loans and investment portfolios. So they would require information on their client emissions, but those data are not always available.

Bentley Kaplan:

So as Carrie tells us, banks could be looking at both physical climate risks, like if a hurricane knocks out some warehouse infrastructure and those related to a low carbon transition. Which not only means a shift in technology, but also policy changes. And it's an appreciable challenge for banks to map out their risk exposure when it comes to climate change. Because debt issued to a single company means that a bank then takes on a mix of both physical and transition risk from that single company, depending on where its operations are or how it earns money or the supply chains that it relies on. And layering hundreds of other loans or investments on top of that, things can get complicated very quickly. For now, the Federal Reserve has left some wiggle room for the big six US banks. It's not asking for an exhaustive assessment of climate risk, but rather more specific and focused analysis.

As an example, the banks will need to estimate what might happen to their real estate loans if there is a hurricane in the US Northeast. And then if there is a different climate shock, dealer's choice, in a different part of the country. And under transition risks, they're being asked to run two different scenarios to understand the differing impacts of an economy that continues to use fossil fuel versus one that sees carbon output reach zero by 2050. For some banks, this may already be in their risk assessment processes, while others may be figuring out the specifics for the first time. But like the Fed and other banking regulators, understanding climate risk for banks is also a priority for investors. And as a banking analyst and MSCI's ESG research team, Carrie spends a lot of time on research and tools that would help investors answer some core questions about banks and their climate risk.

Carrie Wang:

So first, we definitely have those risk related assessments in our ESG ratings model. That includes the industry breakdown of a bank's entire loan portfolio and how much concentration they have in those carbon intensive sectors such as mining, oil and gas, and also utilities and some others. Outside the ESG rating model, we also collect companies' decarbonization target data, and then we assess their alignment with either 1.5 or two degree global warming scenario. And besides all of that, we also collect location data of publicly traded companies. And also we have physical risk models to estimate the impact of extreme weather events on companies' valuation.

Bentley Kaplan:

Right. So Carrie is talking about specific climate related risks that we assess for banks within our ESG ratings model. And in our ESG rating signal, something that captures financially relevant risks and opportunities, we effectively include this climate data within a broader assessment that captures other environmental, social and governance risks. For some investors, this combined signal is useful, but for others it might be that they're looking for an undiluted signal that points only to climate related risks.

But I don't want to get too far into the methodology weeds on this episode because the big story here, is really in how the Federal Reserve has taken this small but meaningful step and about what this initial request for information could mean in the long term. You see, the US Central Bank is by no means alone in wanting to better understand what climate risks could mean for banks. Regulators across many different markets are starting to kick the economic tires in their respective jurisdictions. To take a look at how the regulatory landscape might be shifting, I called up Sita Subramanian, one of our team's policy analysts who sits only a few desks down from Carrie in our New York office.

Sita Subramanian:

Bank regulators in at least 20 major markets across the globe have already conducted a climate stress test or have announced plans to do so. The Bank of England and the European Central Bank were two of the first major regulators to launch a pilot exercise. And then their counterparts in markets like Canada, Hong Kong, Australia, Japan, to name a few, quickly followed suit to better understand how exposed their banks are to climate risks and how prepared they are to deal with them. And now the US Federal Reserve is adding its name to the list of regulators and more and more are expected to follow. But given that these climate stress tests are still relatively new, not all exercises have been designed the same. They have varied in terms of their scope, the range of physical and transition risk channels that they analyze, the treatment of the balance sheet, how they define time horizons, most notably the scenarios that they use.

So many regulators, including the Federal Reserve, are opting for scenarios that are being designed by the network for greening the financial system or the NGFS. But there's several regulators who have chosen to use unique scenarios, and there's also a number that have chosen to customize these scenarios specific to their market. And that all makes sense. These adjustments are helping to provide better insights into local conditions. And as they've gained more credibility, more and more regulators are also leveraging the NGFS scenarios as a baseline, which is helpful for comparability. But while we observe these differences, what's really common across all of these climate stress tests is that they're capacity building exercises. They're really designed to get banks thinking about climate as part of their routine risk management processes. It's an opportunity for them to showcase their preparedness to regulators and all without having capital consequences, at least for the time being.

Bentley Kaplan:

Right. So there is clear and growing interest in these climate stress tests. And banks as a result might be undergoing pressure to measure and report on these risks. And trying to understand just how much pressure is something that Sita looked at as part of our annual ESG and climate trends to watch research. Sita along with her co-authors and Anqi Liang and Simone Ruiz-Vergote looked at how well banks across different jurisdictions are reporting on specific climate risk metrics. And it's a topic that all three researchers will be watching closely in 2023 because in their analysis Sita and our co-authors found that there are quite a few more gaps than investors might have hoped.

Sita Subramanian:

So as we've talked about, these climate stress tests have largely been learning exercises to date. But now we're seeing regulators more and more systematically incorporate climate into routine bank

supervision. We're also seeing regulators in the EU, in the UK even go to the next step and examine the potential role that climate could play in capital risk requirements. But as we've talked about, banks still have a ways to go when it comes to climate scenario analysis and fully integrating climate into their internal risk models. The majority of banks are not yet taking climate into account when they assess the credit risk of their portfolios. And a number of banks are still developing their internal climate stress testing frameworks. But even for those that are farther along, the climate stress test that have been conducted to date have revealed that there's still a number of data gaps that exist like on Scope three or finance emissions or on the transition plans of the counterparties that banks are lending to.

And so filling these gaps are all going to be really critical for investors who want to have meaningful and comparable results. But the mainstreaming of climate stress testing really does stand to be immensely useful for the investment community. For one, they're modeling a risk that's been little explored in the banking sector, which is responsible for financing a large part of the real economy. They're providing critical information to gauge the financial stability implications of climate change, and they're really underscoring the importance of accurate and comparable data on climate. So, while banks and their regulators are still very much learning the language of climate stress testing with time, we might see these results actually being really helpful for developing climate risk mitigation strategies and managing capital, but definitely for communicating with their investors.

Bentley Kaplan:

Okay. As Sita lays it out, there's still quite a big gap between what banks are reporting on and what they could be reporting on. And that kind of aligns with where regulators are, because measuring climate risk for financial institutions is not straightforward. Banks are trying to figure out what they should be measuring, how to measure it, and then how to communicate it to their stakeholders. And that's before even thinking about acting on those risks. For regulators, the stakes are arguably even higher. They're the ones that are putting in the guardrails. And for now, institutions like the Federal Reserve are testing out the waters through requests for information and opening the door for comment. But at some point, a regulator may have to draw a line in the sand to make a call on what constitutes reasonable risk and what reasonable risk mitigation actually looks like.

And because of their central position in an economy as a conduit of capital, and because they touch on so many different stakeholders, from the giddy heights of large corporate loans to the mundane call center music that you're sitting through as you try to change your billing address, ultimately the approach that banks take to climate change, whether willingly or through regulation, could have profound and lasting consequences. For now, the Fed has not made any concrete requirements over how banks should report or manage their climate risks. But Michael Barr, the Fed vice chair for supervision, was fairly clear when he said the Fed has narrow but important responsibilities regarding climate related financial risks to ensure that banks understand and manage the material risks, including the financial risks from climate change.

So on a good day, I can think of a neat and connecting thread from one story to another, but my mind is still clearing out some holiday rust. So truly, we are hitting a hard turn for our next story. And this one was actually more of a passing curiosity for me, at least at first. And what spurred this was a bunch of headlines talking about the anger and subsequent lawsuit of Taylor Swift fans or Swifties directed at Live Nation, a concert and ticketing company. Now through a combination of having young kids and then having to go through COVID, I confess it's been a long while since I've actually had to try and buy concert tickets myself. So to try and get to the bottom of the story, I look no further than one of MSCI's in-house Swifties, Helen Marlow out of our London office, who also happens to cover media and entertainment companies for us. And Helen, bless, was very patient in explaining how the kids are buying tickets these days and why it may have gone a little awry for Taylor Swift's upcoming Eras tour.

Helen Marlow:

Yeah, so if you want to go to a concert these days, the chances are that you are most likely to go through Ticketmaster. And the experience is not always the best, especially if you're joining a popular event. You have to first go through a digital queue, and often then you're competing with a lot of other fans, but also scalpers and bots. And then they will then go on to resell these tickets onto the secondary market. And then when you get to the point where you know, finally got to the tickets, there's a wide range of different types of tickets. So you're not really sure kind of what is a good price point. It's not very transparent. And finally, when you do get to the end of your purchasing cycle, there's a bunch of hidden fees. It's so often handling fees or delivery fees, so it leaves customers quite frustrated by the whole experience.

Bentley Kaplan:

Okay. So yes, things did go a little awry for those fans trying to land Taylor Swift tickets in the presale site. From what I can gather, there was intended to be a sort of early sale for 1.5 million verified human fans before ultimately opening up for the general public. But 14 million users, which included bots ultimately swamped the pre-sale site, which meant delays and lockouts and Live Nation did manage to sell 2 million tickets in pre-sale and then canceled the general public sale a bit later. So I can appreciate the grievance, and the more that I spoke to Helen, the more it actually became clear to me that this was more a case of a Swifty straw breaking the camel's back rather than this single fiasco being the catalyst for so much negative internet backlash. And a lot of this has to do with Live Nation's track record.

Helen Marlow:

I guess it's not something new. I think there's been a lot of customer complaints in the past. So, it's not specifically the Taylor Swift concert. I think the Taylor Swift concert just highlighted this sheer volume and how the company wasn't able to handle it, but criticism has been going on for years, if not decades. You think back to 1994, Pearl Jam had a lawsuit against Ticketmaster on the unfair practices. So, I guess now it's because there's been so many complaints, there's been more lawsuits from Swifties. And also, politicians have started kind of jumping in and calling for a bit more probe into some of these anti-competitive practices. What's also important to note is that Live Nation and Ticketmaster merged in 2010, and so they hold pretty much monopoly in the US market. And that comes with a lot of questions into how they're actually handling some of these issues, especially when it comes to bots or scalpers and the secondary market and ensuring that they provide a fair service for customers.

Bentley Kaplan:

Right. Ticketmaster merged with Live Nation in 2010, and that has turned out to be a pretty influential decision. What it meant was that you had one of the world's biggest promoters and producers of concerts joining forces with one of the world's biggest ticketing companies. And this all in one solution was marketed as a way to quote, "expand access, improve transparency, and deliver artists and fans more choice, driving greater attendance at live events and bringing more value to all major constituents in the industry." But as Helen points out, there are certainly some aggrieved constituents of the music business, not only angry fans, but increasingly frustrated artists as well. Investors, though, as long as not directly related to a Swifty or another Aggrieved fan, might have been able to weather these criticisms without too much worry. After all, the company has enjoyed pretty steady growth in revenue since its merger.

But taking an ESG lens to a company like Live Nation can be quite revealing in particular, looking at externalities, the negative social or environmental impacts that occur because of the company's operations. And in this case, I wanted to look at the MSCI ESG controversies report for Live Nation. And as Helen alluded to, the company faces multiple lawsuits and investigations over anti-competitive practices, deceptive selling practices, over pricing and providing unsafe concert conditions. And this results in the company's scoring a one out of 10 on its social pillar. But why this really matters is that these growing negative social impacts can start to turn the screws, start to add pressure, initially from stakeholders like customers, but then artists themselves. And the customers of alleged monopolies might identify with some of the complaints of Swifties, like poor service and overpricing. But then as these issues escalate, regulators and lawmakers start to take notice.

And this transition can ultimately be like a closing of a circle where fines or legal changes transform these externalities into direct financial consequences for a company. And then a company that had enjoyed an alleged monopoly over the live music industry starts to find itself on the end of multiple investigations. And as of Tuesday this week, the subject of a US Senate hearing. Now at the time of recording, it remains to be seen what the outcomes of these investigations and hearings and lawsuits will be for Live Nation.

But this story does offer a helpful example of how an ESG perspective can offer new ways of looking at the same company, how it can help investors to consider the role of a company's social externalities, and how it's ultimately regulated. Because regulators and lawmakers are looking at questions of stakeholder protection, asking questions like, what's reasonable and what's fair? And in this case, trying to figure out exactly what is driving the bad blood between music bands and the company, or whether the mounting controversies stemming from Live Nation's operations will leave regulators with little choice but to act and to leave them shaking their proverbial head saying, "Look what you made me do."

And that is it for the week. A massive thanks to Carrie and Sita and Helen for their take on the news with an ESG twist. Thank you very much for tuning in. It's great to be back behind the mic and to give Mike a week off from the sweat and toil. That said, he'll be back next week, so please do tune in to hear from our favorite ESG journeyman. If you have the time, do drop us a review or a comment on your platform of choice. We would thank you most kindly. But for now, get back to your day or your night and think of us the next time you swing by the bank or when your next bopping along to your favorite jams, whether that's amid thousands of other fans or in the relative comfort of your own home.

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