GUEST COMMENTARY - Secured debt carbon assessment *By John Ryan of Greengate, LLC*

Over 30 per cent of worldwide greenhouse gas (GHG) emissions arise from end-user assets (vehicles and other transport assets, residential and commercial buildings) and the operation of discrete, capital-intensive facilities (industrial and infrastructure projects). Design and purchase decisions associated with such assets will have a major impact on climate change mitigation. In turn, climate change regulation and risk factors can have a significant effect on the value of long-lived assets.

Such assets are also intrinsic to large segments of global economic activity and associated investment. But in contrast to other sectors of economic value, these types of end-user or project assets are not predominantly owned by publicly-listed companies. Rather, they are often owned by individuals or private development and investment companies. As such, the assets per se are outside the scope of institutional equity investors.

However, these assets are often surprisingly closely connected to the capital markets in another way. Long-lived assets owned by individuals or unrated private companies are almost always financed with a high proportion of secured debt.

Historically, such debt was held to maturity in the portfolios of banks and insurance companies. Increasingly, lenders are disintermediated and secured debt is placed directly or indirectly (through securitised pools) in the global long-term credit markets as public or 144(a) bonds or widely-syndicated bank loans, and bought by fixed-income institutional investors.

Compared to other large-scale capital market instruments (equity, corporate debt) there is a relatively direct connection between the institutional investor and a tangible asset.

An unfortunate example of this connection: subprime lending. But on the climate side, the connection may be used in positive ways.

Fixed-income investors may have an interest in a "secured debt carbon assessment," an assessment of the GHG emissions profile and other climate change-related information of the assets underlying their secured debt investments.

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Such an assessment would be a fixed-income analogue to a large programme focused on listed equities like the Carbon Disclosure Project (CDP). Another relevant precedent is a recent study by the Ceres Group (Corporate Governance and Climate Change: The Banking Sector January 2008) of disclosure about bank lending and debt in connection with climate change.

Institutional investor interest in carbon disclosure for secured debt would arise from two motivations:

- Risk management of climate change factors associated with the physical asset value or credit quality of the secured loan; or
- Implementation of an investor's socially responsible investing policies with regard to the 'carbon footprint' of the financed assets.

The relative importance of these factors will vary with asset class. Notwithstanding the current disruptions, secured debt classes are generally highly-rated, low-risk, long-term investments. While the long tenor means that there is exposure to climate change risks, these risks are not likely to be a predominant part of the investor's downside analysis - interest rate movement and overall economic conditions are more directly relevant.

Perhaps more significant is the likelihood that an investor in long-term, low-risk assets (e.g. pension funds, major insurance companies) will have institutional socially responsible investing policies that are seriously pursued or even required by statute. Disclosure of the assets' carbon footprint in connection with long-term climate change mitigation will be useful in the context of these important policies.

Of course, given the current state of the credit markets (particularly securitised debt) many fixed-income investors will have other, shorter-term concerns. But these markets will stabilise – secured debt and securitisation are too fundamental to stop growing, albeit more slowly than before. In a much less liquid market, investors' influence will be all the more powerful: asking for carbon disclosure now, just as the markets are establishing new standards of transparency, may well be optimal timing.

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