BROKEN BONDS

What's the ethical way forward when ESG-oriented debt becomes a dangerous burden?

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Well-managed debt can be empowering for individuals, families, companies and communities. Indeed, equal access to borrowing is a critical part of economic justice, and there are certainly plenty of environmental, social and governance (ESG)-minded reasons to own bonds. For example, they enable corporate borrowers to invest in innovation, modernized manufacturing, supply chain efficiency or even remedial efforts such as environmental clean-up. Municipal bonds can fund infrastructure improvements to protect communities from floods or provide access to clean drinking water. A mortgage can put a family in a home and a microloan can get a new business off the ground.

But is there a danger that a bond investment made with sustainable intentions can become unsustainable? And what can be done to ensure that the investment process manages any unintended consequences, getting the capital where it is needed without creating or amplifying problems?

It's easy to wag our fingers at families who recreationally or compulsively consume beyond their means, but for many others, consumer credit is what keeps food on the table and clothes on their backs.

It is also likely that those with limited financial resources are paying the highest rates to access that credit, which creates a vicious cycle where servicing the debt overwhelms the debtor. The prime rate has been in single digits for years and yet consumer credit lenders charge around 30% to those who are least able to pay. Even with high rates of default, this is attractive enough for Wall Street to securitize and trade.

Student debt presents similar issues, even with a government backstop. A student loan can be exactly the leg-up an individual needs to get an education and build, change or enhance a career. It makes sense to give people the opportunity to borrow against their future potential, essentially securing the loan with their careers. But the debt can climb to hundreds of thousands of dollars. That leaves borrowers starting their working lives with a mortgage-sized crater and too small an economic shovel to fill it.

THE BIGGER PICTURE

But what does this $5 trillion problem have to do with ESG bond portfolios?

There is a critical question to be asked when it comes to evaluating these debt securities: what is the risk to the borrower? A loan may well be made with all the best intentions, but it can still wreak havoc down the road.

Municipal bonds present a collective version of the problem. For several years we have been watching the tragic collapse of Puerto Rico's economy under the crushing weight of municipal debt. Now, in the wake of a glancing blow from one hurricane and a direct hit from another, we see a society in complete crisis as the infrastructure funded by those bonds is smashed. A series of arcane laws has the island virtually cornered when it comes to finding an economic path to recovery. The situation raises a number of questions about whether that much debt should ever have been hung around the necks of the people of Puerto Rico. There was insufficient equity investment in businesses, young talent was leaving the island, laws and regulations made everything more expensive, and Puerto Rico does not have the same mechanisms as municipalities and states on the US mainland to discharge the debt if the population cannot support it.

In retrospect, we have to ask whether debt issuance was the right approach. Are the net social and economic consequences of that debt graver than the problems the bonds were meant to address in the first place?

GOOD BONDS GONE BAD

Whether it's municipal debt, project finance, mortgages, credit cards, payday loans, microfinance loans or green bonds, there are downstream environmental and societal outcomes – good and bad – that must be addressed.

Portfolio management decisions also have fiduciary implications. Where does the responsibility lie for an ESG-oriented bond manager addressing a default? What if the intention was to facilitate some social or environmental good through the proceeds of the bond, but chasing the borrower through bankruptcy court inflicts even greater harm?

Evaluating questions like these is not just a matter of finding the right line between being a socially driven investor or being a savage capitalist. It is also about inquiring of the portfolio manager whether there is comprehensive ESG analysis in place that integrates all stakeholders. How the manager addresses potential adverse impacts on the borrower and whether those factors inform ownership over the debt instrument's lifecycle may be the hallmarks of truly sustainable bond investing. ■