DSC Meridian Capital LP is an opportunistic, event-driven credit investment firm founded by Sheru Chowdhry, the former Head of Credit Research & Co-Portfolio Manager of the Paulson Credit Fund (2004-2017). The firm seeks to generate absolute returns through the credit cycle. DSC Meridian will prioritize principal protection, liquidity and shorting at the top of the credit cycle, and then shift portfolio focus to capital appreciation and equity-like upside at the bottom of the cycle. DSC Meridian will invest both long and short, across small, mid, and large-sized capital structures, and across the full spectrum of credit opportunities from performing, stressed and distressed credit (bankruptcy reorganizations, litigations, liquidations) to post re-organization, event-driven equities and capital structure arbitrage. The firm integrates material ESG factors throughout the investment process and pursues an active corporate engagement strategy to help shape positive ESG-related outcomes.

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DSC Meridian ESG Leader, Spotlight Series: Featuring Steven M. Rothstein, Managing Director, Ceres

Paula Luff
Director of ESG Research & Engagement

Steven Rothstein
Managing Director at Ceres

Executive Summary:

Steven M. Rothstein is the founding Managing Director of the Ceres Accelerator for Sustainable Capital Markets. Ceres Accelerator aims to transform the practices and policies that govern capital markets in order to accelerate reduction of the worst financial impacts of the climate crisis and other sustainability threats.

Steven has 40 years of experience starting, managing and growing several non-profit, social change and government organizations. After college he was on the founding team of Citizens Energy Corporation, the world's only non-profit oil company. After several years, Steven went on to manage $300 million for Massachusetts's state agency's programs for human services and facilities for people with intellectual disabilities. He then started and ran Environmental Futures, a management and market consulting company serving a wide range of enterprises in the US and internationally seeking to grow their environmental work. He also ran the New England market for Constellation's entry and expansion into this market as a successful electricity broker.

Steven recently sat down with us as part of our ESG spotlight series, covering climate change risk, emissions disclosure, ESG regulation and the evolving policy landscape.

Opinions expressed herein are the own opinions of Mr. Rothstein and Ms. Luff and are not necessarily the opinions of DSC Meridian Capital LP or Ceres or their respective partners, employees or affiliates. The interview has been edited for clarity.

Paula Luff (PL): Welcome, Steven. So glad you could join us today. Would you give us a little overview of Ceres for the benefit of our readers, and your role at Ceres Accelerator?

Steven Rothstein (SR): Sure! Ceres is a sustainability non-profit organization started over 30 years ago. Our tagline is: sustainability is our business. We help investors, companies, and other parties think about how to use the leverage of the private sector to become more sustainable. Ceres' investor network represents over $46 trillion of assets under management. We also work with multiple Fortune 500 companies to help them become more sustainable from the supply chain to the board room. We work on policy issues, on Capitol Hill, at the White House and in seventeen state capitals, on a variety of topics from energy issues to infrastructure and more.

I am the founding Managing Director of the Ceres Accelerator for Sustainable Capital Markets. The basic idea of the Accelerator is: how do we make the capital markets more sustainable? How do we ensure that in the years to come, our capital markets can be robust, profitable, and strong—yet also sustainable from a financial perspective, from a human capital perspective, from a diversity perspective? In the short term, we're working through a variety of regulatory issues in the banking, insurance, asset management, and pension industries.

PL: As we do our underwriting of companies, we often see climate change, adverse weather events, or supply chain disruptions because of weather or some climate change risk in their 10-Ks. Yet we rarely find evidence elsewhere that they're actively managing these risks in their sustainability or other disclosures, for example. That may be about to change as mandatory disclosure is well established in Europe and quite possibly coming to the US. The SEC is considering mandatory disclosure as we speak. Where do you see this all heading?

SR: Let me start with the marketplace, investors, and regulators. First: companies cannot manage a problem if they can't measure it. Now, measuring alone doesn't solve it, but you can't solve it without measurement.

We're not measuring climate risk in a consistent way. The vast majority of Fortune 500 companies, and many smaller ones, are using some type of voluntary climate disclosure framework. All the companies in the alphabet soup of disclosure are great organizations—including GRI, SASB, CDP. They all do a great job, but they are looking at different things. So, if you're an investor and you want to look at emissions across five steel, five agricultural, five real estate companies, etc, whatever it might be, it's impossible to do so now.

We believe first that there has to be mandatory climate disclosure. We appreciate the initial steps the SEC is taking, but there is so much more that needs to happen. Our country is behind, and climate is one of those areas that if we win slowly, we've lost. We need to move fast. Ceres issued two reports (in June 2020 and April 2021) talking about regulatory recommendations. We had over fifty different recommendations for the Federal Reserve, FDIC, and SEC, and while there is a variety of things we can talk about, the financial regulators need to play a critical role just as they did during the pandemic.

In addition—not instead of—there also must be voluntary action: from banks, from companies in the real economy, and investors. The large banks have all made net-zero-by-2050 commitments which is a good first step, but that's all it is: a first step. Think about a long journey. Yes, you want to know where you're going, but you also need to know how you are going to get there. They need to set concrete science-based targets for the short term, for 2030 or 2025. Then, they need to work with their customers to achieve that, just like investors. We're asking every investor to set a 2050 goal and a 2030 short term goal, and we also have a new document for the ICAPs—investor climate action plan.

So how do you move from here to there? We call it a "climate action plan ladder." Everyone is in a different place, and their portfolios are a little different. But there are established steps to go through having to do with everything from the companies you invest in, to the role of policy, from governance issues to corporate structures. These various areas have to be integrated.

I've spent 40 years in and around nonprofits, so I have to be an incurable optimist. But we're running out of time. The recent initiatives of investors, banks, insurance, and regulators are all good, but they're first steps. We need to do more, and we need to do it faster.

PL: One of the challenges we see is that less than 25% of high yield issuers have set a net-zero or science-based target for 2050 or 2040. They do not have aggressive enough interim targets to get there. To your point, we know the destination and we're committing to it, but we don't know how we're going to get there. Is there any interesting work going on about the role of innovation in meeting net zero objectives?

SR: I'd like to talk about the data behind the innovation. I would like to go to a company in your portfolio and ask questions like, "Do you know the data for when the next pandemic will hit?" "Should you be planning for it?" "How will cyber risk affect your company?" The reality is that the future, as Yogi Berra said, is very hard to predict.

We know more about climate risk than we do about other risks. To put it in stark contrast, we clearly knew about the 2008 housing crisis. We know more about climate today, and the numbers are much bigger, than that crisis. Yes, we don't have perfect data, but we have a lot of data, and if we build on it, if more people use it, the market will evolve.

Second, there's work to be done all the time. I just read an article last night about catastrophe risk modeling (modeling of hurricanes and storms). There is more data about transition risk. Last year, the oil companies wrote off $145 billion in investments—pipes, flanges, and drills that they're never going to get recovery. That's $145 billion that some combination of investors, banks, and insurance companies will take a loss on. That number is only going to grow.

Ceres did a report last September about the risk to the banks. If you look roughly at the top twenty banks, take just a slice of their Syndicated Loan Portfolio—in that alone, using the same model that European Central Bank uses, we identified $500 billion of potential exposure.
Of course, it doesn't mean they're going to lose all of that, but the potential exposure exists. So, we need more information.

It's a virtuous cycle. If owners and investors are asking for this information, the companies are going to give it up. The more regulatory requirements for mandatory consistent processes exist, the more consistency we will see. For example, imagine we didn't have mandatory financial reports. Company A would file a balance sheet, company B would file an income statement, and so on—we wouldn't be able to compare them. That's the world we're in today. We're in a Tower of Babel on climate data.

PL: Talk to us a little bit about the EU taxonomy which is tightening requirements around company disclosures and seeking to standardize definitions around sustainability and ESG. I'd also like to hear your thoughts on SFDR [sustainable finance disclosure regulation] and recent potential regulatory moves here in the US.

SR: In terms of regulatory pressure, yes, Europe is way ahead of us. I'll give you one example: in 2016, the French Central Bank started a mandatory disclosure for certain classes of financial institutions. At the end of 2020 they examined what the result was of this disclosure. Because of disclosure rules, those financial institutions that were covered reduced their loans by 40 percent or 23 billion Euros. That's 23 billion Euros that were not loaned to high emitting fossil fuels companies. That's very significant. So, I think there's important work being done by Europe and Asia and other places.

Now the NGFS (Network for Greening the Financial System) has around 90 members globally—we were one of the late ones to the party but we're there. The Federal Reserve is there, the New York Department of Financial Services is a member, so that's great. I think we can learn a lot from European leadership in this area. The United States recently joined NGFS, we are members of the International Security Group (ISG), International Organization of Securities Commissions (IOSCO), International Financial Reporting Standards Foundation (IFRS), a whole alphabet soup of them.

While I'm not an expert on it, generally I think the taxonomy is a great step forward and there will be a lot of adoptions. Like many things, the devil is in the details. But I think fundamentally, you can't measure emissions the same for a real estate company as you do for an agricultural company, as you do a cement company, or whatever else. It has to be broken down eventually by industry.

If you look at the FASB rules, we didn't start in the 1930s with a set of rules and never change them. They're updated on a regular basis. And we're going to learn more about science and technology and climate, so we hope that the SEC and the Federal Reserve have great rules soon.

This summer, I testified before Congress about banking regulations. I do think we need to have climate stress tests so that if somebody were to say to a bank, "There are two loans you're going to make. One has more climate risk than the other," the bank would say, "I'm not going to do it, or I'm going to charge a higher interest rate to compensate for that risk."

But we are not doing that in climate. Whether it's two houses—one next to the ocean, one twenty miles in—or one fossil fuel company over another, we're not factoring in climate risk. Many of these are long-term loans. And in some sectors, it's even less transparent; the municipal bond market is one of those areas. There needs to be a combination with voluntary action.

One very simple thing that we need is policy updates for bank regulators. When these examiners go to banks, they don't know what questions to ask for climate. Their policy manual needs to be updated so they know what questions to ask that are relevant to each bank and its area. Take a local bank that operates in a high-risk area because of fire or flood or something else—to not ask these climate questions is akin to malpractice in my opinion.

PL: Is anything interesting percolating at the state level that might take hold?

SR: There's so much happening. First, we're unique globally that we have this series of Federal regulators, then every state has a banking regulator, an insurance regulator, a securities regulator, and others. Sometimes there are three separate agencies, sometimes they're combined.

If you look at insurance first, there is a group through the National Association of Insurance Commissioners that requires mandatory climate disclosure for insurance companies. The top 70 percent of insurance companies have been filing disclosures. Now it's not as detailed, and they are now shifting to TCFD (Task Force on Climate-Related Financial Disclosure), but that's a good step. They're looking at it very seriously. There are some insurance regulators in particular—California, state of Washington, New York, Connecticut, and others that have various policies. New York, for example, just finished a comment period. They have a requirement for the insurance companies that they want to put in place. There are some great things happening on the insurance front.

And, then in legislation! A recent bill passed in Connecticut that requires the insurance commissioner to address climate as part of the risk portfolio they look at. In California, the Governor issued an executive order looking at state procurement. Could the state say, for example, every vendor for the state of California over a certain size has to meet certain climate disclosure rules? President Biden just announced his plan to implement this at the federal level as well. Rules are going to be put in place. Our states have always been a learning laboratory throughout our entire democracy, and they are in this realm, too. If you're a federal employee or retiree, your pension fund goes into the federal thrift program. The Thrift Savings Plan is a large pension fund—as of December 2020, they had almost $735 billion in assets under management. If you're an employee, you cannot sign up for an ESG fund in this plan. It's not allowed; they don't have one. The U.S. Government Accountability Office (GAO) just came out with a report declaring that they're increasing risk by not allowing people to do that.

PL: I remember fighting that fight at one of my corporate jobs. The treasurer of the company said basically, "I have fiduciary responsibility; I can't do that."

SR: Right. And that's baloney. First, we have legal opinions that say that. Second, the Department of Labor said it. Third, the returns speak for themselves. As you know, if someone had invested in the S&P 500, and someone else had invested in the S&P 500 at the same time with no fossil fuel, the one without fossil fuel would have done a lot better. There's lots of data now that show that ESG investment returns are now at market or better than market.

PL: So, what gives you hope? You said you're an eternal optimist, so what are you seeing that gives you hope that we'll avoid the worst impacts of climate change? That we'll have more decision-useful data in the interim?

SR: So much! A year ago, we started working with investors—including DSC Meridian and others—to talk about this net-zero commitment. A year ago, I think there was only a single investment firm in the United States who had committed to this. In April 2021, two days before Earth Day, we announced with international partners that $37 trillion of assets under management have committed to reaching net zero emissions by 2050 or sooner and are setting 2030 emissions reduction targets. That's roughly 38% of the assets under management worldwide.

Second, I can give you a long list of executive actions and regulatory actions from the Biden administration that are just beginning to have their impact.

Third, I'm absolutely inspired by young people. I see hope all the time in what they're doing, both here and around the world, which brings a great sense of optimism.

Fourth is that we've all lived through this awful crisis called the COVID-19 pandemic. Over four million human lives lost worldwide, over 600,000 of them in the United States. I think people are more aware of the potential impact of what nature can do. And as awful as that was and continues to be for many people, there is no vaccine for climate change.

PL: We say that all the time around DSC. There is no vaccine for climate change. All pandemics end, but climate change is only getting worse.

SR: Right.

PL: And we're only accumulating more and more carbon, right? It's an exponential spiral.

SR: That's the negative part. The positive part is an increasing awareness. Just last year, I talked to over a thousand regulators, literally over a thousand. Most of those conversations were, "Is climate change real? Will it affect bank stability? Is it really my job as a banking regulator to think about this?" Today, the conversations are not that. They're more along the lines of, "What should we do? What kind of stress test do we need, what type of management disclosure?" It's no longer if, but more about how.

PL: Steven, thank you for this conversation, and for the work you're doing with Ceres. You've been so generous with your time.

SR: Thank you! The work you're doing is great, and I'm glad to talk with you.

LEARN MORE

If you would like to learn more about DSC Meridian, please contact:

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