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ESG Performance and the Credit Markets

The view that it is not only possible to do well by doing good, but that doing good is critical to doing well in the long run, has come to the fore in the investment community. Environmental, social and governance (ESG) issues are, as State Street says, “a matter of value, not values.” In his much-publicized letter to CEOs, BlackRock founder Larry Fink augured “a profound reassessment of risk and asset values,” noting “climate risk is investment risk.” The statement can be generalized: ESG risk is credit risk. Recognizing this reality, investors have increasingly demanded from companies ESG disclosure alongside traditional financial metrics, with profound implications for corporate credit.

Over time, we expect companies to find their cost of capital more directly tied to their ESG risk, which firms are lining up to help investors evaluate. All of the major credit ratings agencies have signed onto the Principles for Responsible Investment statement that ESG factors can weigh on default probability, and consider such factors in their ratings. Some also offer stand-alone ESG products, as do independent specialist firms. As an indicator of the growing demand for ESG data and analysis, both Moody’s and S&P made strategic acquisitions in the ESG-data space in 2019. Morningstar took a 40 percent stake in Sustainalytics in 2017.

Notwithstanding the plethora of firms, investors and analysts propounding their own views on which ESG metrics matter and to what degree, the vast potential of ESG-informed financing has yet to be tapped. Accelerating its growth depends on the availability of consistent and comparable data across firms. Universally acknowledged as lacking today, standardization is coming. The World Economic Forum, for example, recently released a [Consultation Draft](#) of proposed common standards for corporate disclosure of ESG factors. Companies will have little choice but to respond to investor, and in some cases regulatory, demand for useful information.

Widespread, comparable ESG disclosure portends more than just facilitation of risk assessment: financial innovation will follow. Unlike their equity cousins, ESG bond indexes are few, and non-existent in the high-yield realm. That will change. Borrowers, particularly in Europe, are already using “green bonds” (proceeds earmarked for environmentally friendly projects) and “sustainability-linked loans” (pricing tied to bespoke sustainability targets) to demonstrate commitment to ESG issues. While the actual pricing impact of ESG performance in such products is currently marginal, often only a few basis points, having an infrastructure that ties the cost of capital to ESG performance will enable rapid change as improved statistics increase transparency and diminish fears of “greenwashing” (*i.e.*, investor concerns about buying genuine ESG performance rather than public relations coups). Today these products operate as signaling devices to stakeholders with respect to ESG commitment; tomorrow they may materially affect debt service.

We encourage companies to be proactive in choosing their individual ESG disclosures, to stay abreast of the ESG-related financing trends in their industry and to work with rating agencies, trade groups and leading sustainability-measuring organizations, so that their voices are heard as the standard-setting process unfolds.

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