The Rise Of ESG In Fixed Income

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Key Takeaways

- ESG has expanded from a niche sector in the equity market to the mainstream fixed-income sphere.
- The credit implications of ESG issues have increasingly become more visible and material, leading to a greater focus by fixed-income market participants.
- Regulators, focused on meeting global commitments, are emphasizing ESG-related disclosure and embedding such concepts into mainstream capital markets.
- Investor demand for fixed-income ESG finance has grown and bred new financial products, a trend that we expect to continue as values-based millennials inherit a massive wealth transfer estimated at $30 trillion.

Environmental, social, and governance (ESG), long considered a niche consideration in equity investing, has made major inroads on the mainstream fixed-income market. Climate change and resource scarcity, workplace productivity and product safety, along with technological advances and changing consumer preferences, are among the ESG-related risk factors that have real credit implications. Regulators, intent on meeting global climate and sustainable development commitments, are working to better integrate ESG concepts into the financial system. Concurrently, investors are not only taking greater interest in how companies address these challenges, but are also avoiding certain investments based on their ESG preferences. In turn, new fixed-income products have been developed and are expanding rapidly to meet growing investor demand. We expect these trends to continue as mainstream capital markets increasingly find ways to address ESG-related risks, many of which are not easily discernable on financial statements. Here, S&P Global Ratings explores the foundations of ESG and what is driving interest, understanding, and adoption in the fixed-income marketplace.

The Foundations Of ESG

ESG is considered within the context of corporate behavior and investment management, and is by no means a new phenomenon. Its history dates back to the 1800s when religious groups established investment guidelines informed by ethical and religious values. The investment approach remained niche in the equity markets but started to grow in popularity following the creation of the first ESG-focused mutual funds in the 1980s. By 1999, the Dow Jones

Sustainability Indices (DJSI) were created, the first global sustainability benchmarks tracking the stock performance of thousands companies in terms of economic, environmental, and social criteria. (DJSI are owned by S&P Dow Jones Indices, a division of S&P Global, as is S&P Global Ratings.) Over the years, ESG investment approaches, along with the terminology, evolved from exclusionary or positive screening, to integrating ESG factors into investment decisions; shareholder advocacy initiatives; voting proxies, where available; and impact investing.

It wasn't until the launch of the UN Principles for Responsible Investment (UN PRI) in 2006 that the concept of ESG started to spread into the mainstream. The investment principles, which encourage the incorporation of ESG factors into investment and ownership decisions, have attracted a global base of signatories, steadily growing from nearly 100 signatories in its infancy to over 1,800, representing nearly all the world's professionally managed assets today. While the equity market has historically been on the front lines of ESG investing, the bond market is quickly catching up.

Investor Demand Accelerates

Assets managed according to ESG strategies reached nearly $23 trillion by 2016, up 25% from 2014, accounting for around one-quarter of professionally managed assets globally, according to the Global Sustainable Investment Alliance's latest review of the state of sustainable investment (see table 1). And in the fixed-income sphere, at S&P Global Ratings we've observed an increase in investor interest in ESG fixed-income investment strategies and consequently greater attention to how entities are navigating environmental and social challenges. Institutional investors such as pension funds and insurers are particularly interested in ESG because it captures long-term and existential risks.

Table

Assets Managed Under ESG Strategies See Strong Growth

Region	2014 (bil. $)	2016 (bil. $)	Growth from 2014 to 2016 (%)	Compound annual growth rate (%)
Europe	10,770	12,040	11.7	5.7
U.S.	6,572	8,723	32.7	15.2
Canada	729	1,086	49.0	22.0
Australia/New Zealand	148	516	247.5	86.4
Asia (excluding Japan)	45	52	15.7	7.6
Japan	7	474	6,689.6	724.0
Total	18,271	22,891	25.2	11.9

ESG--Environmental, social, and governance.

The rise in investor demand has led to an acceleration in new fixed-income markets dedicated to ESG themes. For example, the green bond market, whose proceeds are earmarked for projects with specific environmental objectives, has grown rapidly over the past five years, achieving a compound annual growth rate of 85%. We expect the market to continue to accelerate, reaching $200 billion in new issuance in 2018.

Despite this rapid growth, current demand for green bonds far exceeds supply, which has led to high levels of oversubscription. While this has not always led to pricing advantages, it seems to suggest that longer term and in a higher interest rate environment, it may. The social and sustainable bond market has also emerged alongside the green bond market, where bonds are raised for social projects or a combination of green and social initiatives. Across the board, the UN's Sustainable Development Goals (SDGs) which bridge green, social, and sustainability concepts, have become an overarching ESG framework that some issuers and investors use to align their bonds with positive impact. According to the UN, $3 trillion to $5 trillion will be required annually to achieve the goals by 2030, most of which is expected to come from the private sector, suggesting that the SDG market has significant growth potential.

We expect ESG demand to continue on a growth trajectory as millennials, who by 2025 will collectively comprise 75% of the workforce, place greater emphasis on integrating these values into their investment choices. Indeed, millennials, who are considered a values-driven generation, are poised to receive a wealth transfer estimated at nearly $30 trillion from baby boomers. A 2017 report by Morgan Stanley found that 85% of millennials are interested in sustainable investing and are twice as likely as the general population to invest in companies that have social or environmental targets. In response to this growing demand, nearly half of asset managers polled by Morgan Stanley plan to dedicate entire portfolios to ESG. We also anticipate that asset managers will use ESG factors to help make investment decisions, thereby making ESG management part of their fiduciary duty.

Spotlight On ESG And Credit

This investment approach has gained a foothold in the fixed-income market in recent years largely due to growing recognition that ESG-related issues, while previously thought of as longer term and more esoteric, can present immediate and material credit risks. Weather-related supply chain disruptions, pollution spills, product safety recalls, and workplace fatalities--all under the ESG umbrella--have had financial and credit repercussions. The World Economic Forum, which highlights the most pressing risks we face in its annual Global Risks Report, illustrates the growing severity and frequency of ESG-related risks over the past decade. Environmental or societal factors were among four of the five biggest risks in terms of impact. These risks include extreme weather, water crises, natural disasters, and failure of climate change mitigation and adaptation. In 2008, only one ESG risk--pandemics--made the list. This shows that society is acknowledging that ESG issues are becoming more common and material, resulting in greater attention across the financial markets, including fixed income. For our part, through a series of lookback studies, we have found that ESG factors have become more material credit drivers in the corporate sector. Social issues--such as those related to human capital management, safety management, demography, consumer-related factors, and social cohesion--have also played an increasing role in corporate credit rating actions. While social issues contributed less frequently to rating actions than did environmental factors, when they were material they were overwhelmingly negative to credit quality, reflecting the greater downside risks of social issues. This is particularly true for human capital management and social cohesion, which placed the greatest downward pressure on ratings.

We expect that ESG risks will intensify and new opportunities will emerge as regulations change, demographics shift, and climate change worsens. As a result, fixed-income market participants are paying more attention to these issues and are attempting to differentiate for management's ability to mitigate these increasingly acute risks.

Regulatory Pressures Mounts

The ESG regulatory landscape has also evolved in recent years as global political and financial leaders have underlined the link with finance. Countries around the world have woken up to the pivotal role the finance sector plays in deploying capital to achieve policy objectives. This has in large part been prompted by the Paris Agreement, which will require investment of an estimated US$1 trillion a year to meet its climate targets.

However, the scope of regulation is broader than climate finance. Regulators are now working to embed sustainable finance principles into the financial sector and reorient the economy to meet sustainable development goals. The initiatives vary but are generally centered on enabling financial institutions to integrate ESG into investment decision-making and improve disclosure about these issues.

Europe, in particular, is taking a leadership role in promoting sustainable finance. A number of countries such as France, Germany, Sweden, and the U.K. have issued some form of ESG reporting and disclosure mandates in recent years. France, for example, passed Article 173 of the Energy Transition law, which requires institutional investors to disclose how they are contributing to national carbon targets. The pressure continues to mount following the March 2018 unveiling of the European Commission's report, "Action Plan: Financing Sustainable Growth," a roadmap of reforms built on the recommendations of the High-Level Expert Group (HLEG) on Sustainable Finance. The plan involves a sustainability taxonomy, standards and labels for green financial products, clarification about the duties of institutional investors and asset managers related to their consideration of ESG issues, incorporating sustainability in prudential requirements, and strengthening sustainability disclosure. (S&P Global participated in the HLEG.)

Nevertheless, ESG and sustainable finance-related regulation is not a uniquely European phenomenon. China is also making great strides in promoting sustainable finance. In August 2016, the country launched "Guidelines for Establishing the Green Financial System," and stated officially that a green finance system is part of the country's national strategy. What's more, of the top 50 economies by GDP reviewed by the UN PRI, only Iran had no policy initiatives on sustainable finance. As regulation develops in this area, we expect better disclosure by companies will facilitate the assessment of ESG performance and promote ESG investment.

ESG Is Here To Stay

The recognition of ESG factors as material credit drivers, regulatory pressure to improve disclosure, and growing investor demand are pulling these risks into the fixed-income mainstream. Indeed, as issuers return to the bond market to refinance debt or raise new capital, fixed income is poised to play an important role in illuminating ESG risks and driving capital toward projects with environmental and societal benefits. However, challenges to embedding these risks in the financial system remain, including lack of ESG-related data and limited understanding of how to best report and utilize ESG metrics in investment decision-making. Nonetheless, as these risks grow in importance, companies will be compelled to improve disclosure, both to meet potential compliance obligations and to satisfy investors. While ESG has only recently emerged as a force to be contended with in the fixed-income market, we believe it is only likely to grow in prominence over time.

Related Criteria And Research

- How Social Risks and Opportunities Factor Into Global Corporate Ratings, April 11, 2018
- How Environmental and Climate Risks and Opportunities Factor into Global Corporate Ratings – An Update, Nov. 9, 2017
- How Environmental And Climate Risks Factor Into Global Corporate Ratings, Oct. 21, 2015

This report does not constitute a rating action.