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A Matter of Time – The Growing Use of ESG in Bond Credit Ratings

(Philadelphia, PA, August 24, 2017) – Environmental, social, and governance (ESG) analysis is becoming increasingly important to fixed income asset managers, catching up to U.S. and global equity research where these factors are more firmly entrenched. Although favorable ESG scores may correlate with attractive investment opportunities, the reason has more to do with improving the ability of fixed income investors to correctly price the risk of bonds over longer time periods.

Credit ratings agencies (CRAs) also are taking notice, ramping up coverage of ESG-related risks and publicizing their use in the credit ratings process. To the fixed income team at Brandywine Global, a Legg Mason affiliate, this shift is welcome news.

“The consideration of ESG factors is not a ‘moral obligation’ so much as a necessary step in comprehensive credit rating analysis,” said William Vaughan, global credit research analyst with Brandywine Global, based in London. “By embedding ESG risks meaningfully at the ratings stage, bonds can be priced more accurately to reflect risk over their full duration. More efficient pricing can benefit everyone – issuers, CRAs, and especially investors.”

Given their unique position within fixed income markets, CRAs have considerable influence, access to information, and the ability to ask probing questions of company managements early in the bond issuance process. They can help determine how well companies are adapting to long-term risk factors – a vitally important aspect of high-quality governance. They also have significant powers to push for better standards and compliance on other ESG issues.

“Fixed income investors do not have the same level of built-in influence that equity shareholders enjoy with their voting rights,” Mr. Vaughan noted. “However, greater consideration of ESG factors at the ratings stage means bondholders can access better information to evaluate investments, giving CRAs a means to influence issuers. Eventually, companies that do not address ESG issues likely will have to pay up in terms of the interest percentage paid through the bond coupon.”

Many bond managers have been encouraged by the meaningful progress CRAs have made to identify and reflect ESG risks in the credit rating process, but more needs to be done to ensure that the rewards fixed income investors expect match the level of risk they assume.

“A fundamental concern in buying bonds is that the issuing company survives long enough to pay back or refinance the capital once the bond matures,” Mr. Vaughan explained. “The longer a bond has until maturity, the greater the chances that factors affecting the risks inherent in the bond and the creditworthiness of the issuer will also change. While this creates an interesting challenge for investors, ESG analysis helps foster a longer-term perspective and a more comprehensive understanding of broader risk factors over time.”

A recent report from the United Nations-supported Principles for Responsible Investment (UN PRI), "Shifting Perceptions: ESG, Credit Risk and Ratings, Part 1: The State of Play," concludes that progress is being made to identify and reflect these risks in the credit rating process.

The UN PRI report shows that ratings agencies typically look over three- to five-year periods when assessing investment grade credit, two years or less for high yield, and around 10 years for U.S Treasury and sovereign bonds. These assessments are at odds with bond investors, who often have a longer time horizon.

"CRAs tend to focus on financial factors," Mr. Vaughan said. "This approach implicitly directs attention to the short term because it is difficult to predict future financial performance for most issuers over more than two years."

"It is important for CRAs to take a long-term view and assess a range of factors for longer-dated bonds, particularly among high-yield bond issuers," he continued. "Because many high-yield issuers are private companies, less information is publicly available than on investment grade, and their governance standards can be less robust. High-yield issuers also, by definition, are less likely to be in position to pay back or refinance debt when it matures."

The Brandywine Global team is also concerned with the increasing incidence of "stranded assets," whereby companies write off reserves that may become unviable due to regulatory or economic changes. This practice poses significantly greater risk than it did 10 years ago.

"The chances that a coal extraction company may become stuck with stranded assets on its balance sheet over the next one or two years is relatively minimal," Mr. Vaughan observed. "Expand that time horizon, however, and the picture becomes very different. Governments in many developed and emerging markets are coming under growing pressure to address pollution, while solar and other renewable technologies continue to improve and fall in price."

Mr. Vaughan adds, "Investors considering bonds issued by a company seeking to finance a new coal project must now think very carefully about how to price the risks associated with climate change into those bonds. As the time horizon lengthens, the risk of stranded assets increases. Ultimately, it could end up putting the longevity of the issuer at risk."

"These shifting priorities are why ESG is becoming so important to fixed income investors. It's not so much about what can happen to a bond investment today, but the real risks it could face in the long term."

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[1] Brandywine Global Invest Management (Canada), ULC

[2] Brandywine Global Investment Management (Asia) Pte. Ltd

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