The ESG Pulse

Sustainability-Linked Bonds Are Taking Off

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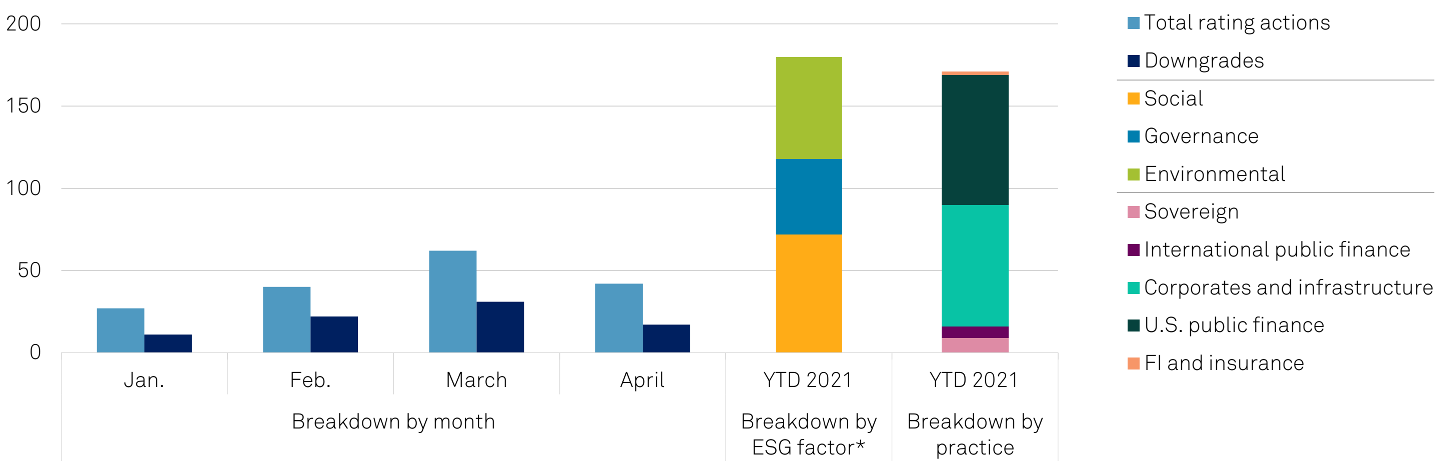
Key Takeaways

- We have published a Request For Comment: Environmental, Social, And Governance (ESG) Principles In Credit Ratings. The criteria proposal formalizes and restates in a single article our analytical approach to incorporating the impact of ESG credit factors in our credit analysis. Accordingly, we do not expect the criteria to affect existing ratings.
- There were 48 ESG-related rating actions in April; 23 were downgrades. Half of the ESG-related actions were driven by governance considerations and 17% related to environmental influence. One-third were directly connected to the pandemic (health and safety), compared to 60% during the first three months of the year.
- Following on the already established growth of sustainability-linked loans, sustainability-linked bonds are equally taking off with $50 billion of issuance forecast this year. Given the flexibility of such instruments, which are based on sustainability performance targets rather than use-of-proceeds green or social bonds, they allow a greater share of issuers to tap the sustainable debt market.
- ESG winds of change could become a tempest for global oil and gas producers, as anticipated in our negative industry revision and rating actions on the majors earlier this year and now evidenced by environmental shareholder activism and the Hague District Court ruling.

Chart 1

ESG-Related Rating Actions Excluding Structured Finance (YTD 2021)



Note: Rating actions comprise rating, CreditWatch, and outlook changes over January-April 2021. *The sum of social, governance and environmental actions exceed total ESG rating actions because some actions were influenced by multiple factors. Excludes rating actions in structured finance. YTD--Year-to-date. ESG--Environmental, social, and governance.

Table 1

ESG-Related Rating Actions Including Structured Finance (YTD 2021)

	Sovereigns	International public finance	U.S. public finance	Corporates and infrastructure	Structured finance	FI and Insurance	Total
Downgrade	6	6	30	38	68	1	149
CreditWatch negative	0	0	39	15	10		64
Downward outlook revision	1	1	8	9	0		19
Upgrade/Upward outlook revision	2	0	2	12	0	1	17
Total ESG-related rating actions*	**9**	**7**	**79**	**74**	**78**	**2**	**249**
Of which social§	7	6	14	45	69		141
Of which governance§	2	1	35	6	0	2	46
Of which environmental§	0	0	39	23	9		71

*Rating actions comprise rating, CreditWatch, and outlook changes over January - April 2021. Structured finance actions relate to ESG impacts by transaction (tranche), while for other sectors the impact is measured on the issuer credit rating. §The sum of social, governance, and environmental actions exceed total ESG rating actions because some actions were influenced by multiple factors.

Following the established growth in sustainability-linked bank loans, sustainability-linked bonds (SLBs) are also taking off as issuers integrate ESG objectives into their strategies and investor are increasingly focused on them. For 2021, sustainability-indexed bond issuance could exceed $50 billion (when extrapolating first-quarter numbers), much higher than the $11 billion issued last year. The asset class is still in its infancy when compared to the approximately $650 billion of green, social, and sustainability use-of-purpose bonds forecast for 2021, and the estimated $150 million-$200 billion in sustainability-linked loan (SLL) issuance this year. For further insights on SLLs, see "Environmental, Social, And Governance: How Sustainability-Linked Debt Has Become A New Asset Class."

What is the difference between sustainability-linked instruments and use-of-proceeds instruments?

Sustainability-linked loans are defined as loan instruments and/or contingent facilities that encourage the borrower's achievement of an ambitious, predetermined, sustainability performance target (SPT). Sustainability-linked bonds are defined as any type of bond instruments for which the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined sustainability/ESG key performance indicators (KPIs or SPTs). In the loan market, most instruments have historically adopted a two-way mechanism, with an equal and opposite benefit or penalty if the company meets, or fails to meet, its performance targets. In the bond market, most instruments have a one-way penalty mechanism, the most common being a one-time 25-basis-point step-up if the targets are not achieved in the specified time frame.

Use-of-proceeds green, social, or sustainability bonds or loans require the issuer to use all the proceeds for a defined environmental or social project.

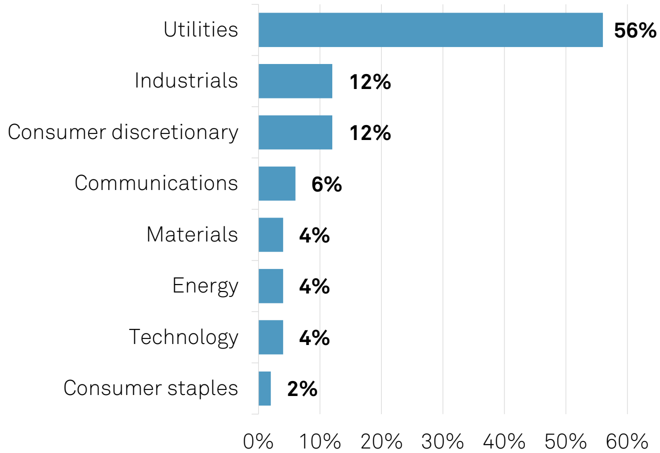
SLB issuance is rapidly diversifying, albeit still concentrated in Europe. This year through early April, 68% of SLBs were issued by European firms, compared with 15% from North America, 10% from Asia-Pacific, and 8% from the Caribbean and Latin America. In December 2020, utility NRG Energy became the first company in North America, followed more recently by Amazon. In Europe, we are seeing new structural developments and widening in terms of issuer type. For instance, France-based mineral producer Imerys included a one-time penalty of 0.5% in its inaugural sustainability-linked bond, which would be paid at maturity if it were to fail to meet its scope 1 and 2 carbon emission targets. EQT became the first private equity firm to place a sustainability-linked bond and also the first to include gender targets in its KPIs (as well as greenhouse gas emission cuts). Swiss pharmaceutical company Novartis' bond included a sustainability performance target to double its patient reach with innovative, more affordable therapies in low and middle income countries by 2025. Issuers in other regions are following suit; United Arab Emirates airline operator Etihad Airways, Brazilian paper and pulp firm Suzano, and India's UltraTech Cement are tapping the SLB market.

High-yield issuers are also considering SLB issuance. U.S. telecoms company Level 3 Financing was the first high-yield issuer to tap the SLB market with a $900 million issuance in January 2021 tied to GHG emission reduction targets. It was soon followed by Brazilian paper producer, Klabin, with an SLB linked to reducing the consumption of natural resources, increasing water and solid waste recycling, and preserving biodiversity in the company's forest areas.

Given the greater flexibility in proceeds use, sustainability-linked instruments have the potential to broaden the universe of issuers who can obtain sustainable financing. Many issuers may not have sufficient capital expenditure allocated to sustainability projects to issue sustainable debt (green or social use-of-proceeds instruments). This includes companies in the consumer discretionary and health care sectors. It also applies to smaller issuers that might lack the capacity to implement the effective tracking or reporting practices required for use-of-proceeds instruments; issuers at the beginning of their sustainability journeys; and those in transitioning and hard-to-abate sectors such as industrials or materials.

Chart 2a

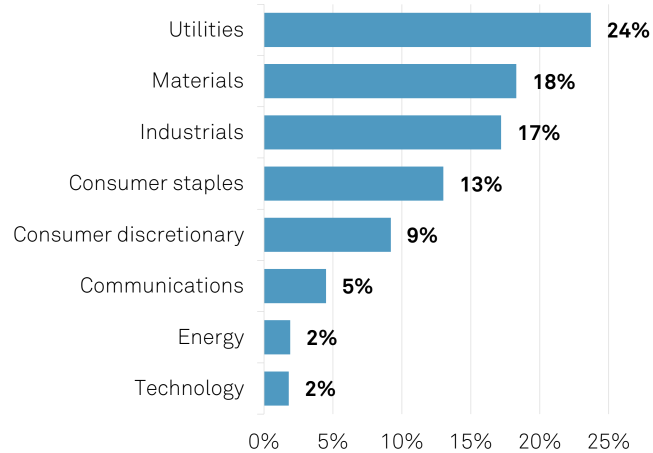
Green Bond Issuance By Nonfinancial Corporate Sector (2020)



Sources: Bloomberg, S&P Global Ratings.

Chart 2b

Sustainability-Linked Bond Issuance By Nonfinancial Corporate Sector (2019-2020)



Sources: Bloomberg, S&P Global Ratings.

Challenges Facing Sustainability-Linked Debt Instruments

Proceed restrictions: There are no restrictions on how the capital raised can be spent, and no consistent tracking of proceed use. This could lead to proceeds funding projects that don't have a clear beneficial impact, increasing the risk of "ESG-washing."

Metric comparability: As the sustainability-linked instrument market is relatively new, there's no standard set of metrics by which to track issuer performance. The KPIs and SPTs are currently unique to each individual entity, which limits comparability of one set of SPTs or KPIs to another.

Metric relevance: Relevant KPIs may vary depending on an entity's industry, business model, geography, and sustainability trajectory. In some cases, metrics set by an issuer may not apply to a substantial enough share of its business.

Metric ambition: The KPIs and SPTs may not be overly ambitious or aggressive and may not demonstrate a significant improvement over an issuer's business-as-usual strategy.

Performance reliability: Issuer performance against set targets is also often self-reported, self-policed, and unaudited, so performance may not be reliably or consistently reported.

Financial penalty: In some cases, the financial penalty for failing to meet the predetermined targets may also not be material enough to encourage the entity to deliver on its goals or tracked frequently or reliably enough to ensure it's demonstrating significant sustainability performance improvements over the life of the instrument.

As proceeds are not tied to a specific project, improved transparency and reporting practices are key to addressing various challenges, particularly the risk of ESG-washing. Last year, ICMA defined Sustainability-Linked Bond Principles to increase transparency in this part of the debt market. Although these are voluntary guidelines, 81% of sustainability-linked bonds in 2020 were aligned with the principles. We note the particular importance of setting sufficiently ambitious targets--not least because SLBs often adopt a simpler approach in which one KPI is used, whereas SLLs are linked to more than one SPT or KPI (sometimes up to four or five) or to an overall ESG score or rating that captures a combination of ESG indicators. Other challenges also persist, as outlined below.

By contrast, the sustainability-linked hybrid bond market has not developed much so far, notably because the established mechanism for senior bonds is based on a coupon step-up. Under our methodology for corporate issuers, for hybrids to be eligible for intermediate equity content they must be able to conserve cash if the issuer's creditworthiness weakens, and the all-in cost must not increase if a sustainability target is missed. Generally, we would expect a failure to meet a sustainability target to reflect a deviation from strategy and potentially credit trajectory, even if the overall impact is marginal and does not lead to a downgrade or outlook revision.

The ESG Winds Of Change Could Become A Tempest For Global Oil And Gas Producers

In February 2021, we lowered our ratings on Exxon Mobil, Chevron, Shell, Total, and Conoco Phillips by one notch, and assigned a negative outlook to BP. This followed our negative revision of our industry risk assessment for oil and gas exploration and production due to the potential for stricter regulations, substitution, and secular shifts in industry supply/demand fundamentals the energy transition entails. We are now seeing some concrete examples of such risks:

– **Policy uncertainty:** On May 18, 2021, the International Energy Agency issued a report that, for the world to reach net-zero carbon emissions by 2050 and commitments of the Paris Accord, no new investments must be made in fossil fuel supply projects. This will also fuel further the debate in the EU as to whether gas should be included in the green finance taxonomy. European Commissioner for Financial Services, Financial Stability and Capital Markets Union recently stated that the EU may "need to consider legislation to recognize the role of gas in facilitating the switch from coal and oil", which would be vehemently opposed by EU climate advisors.

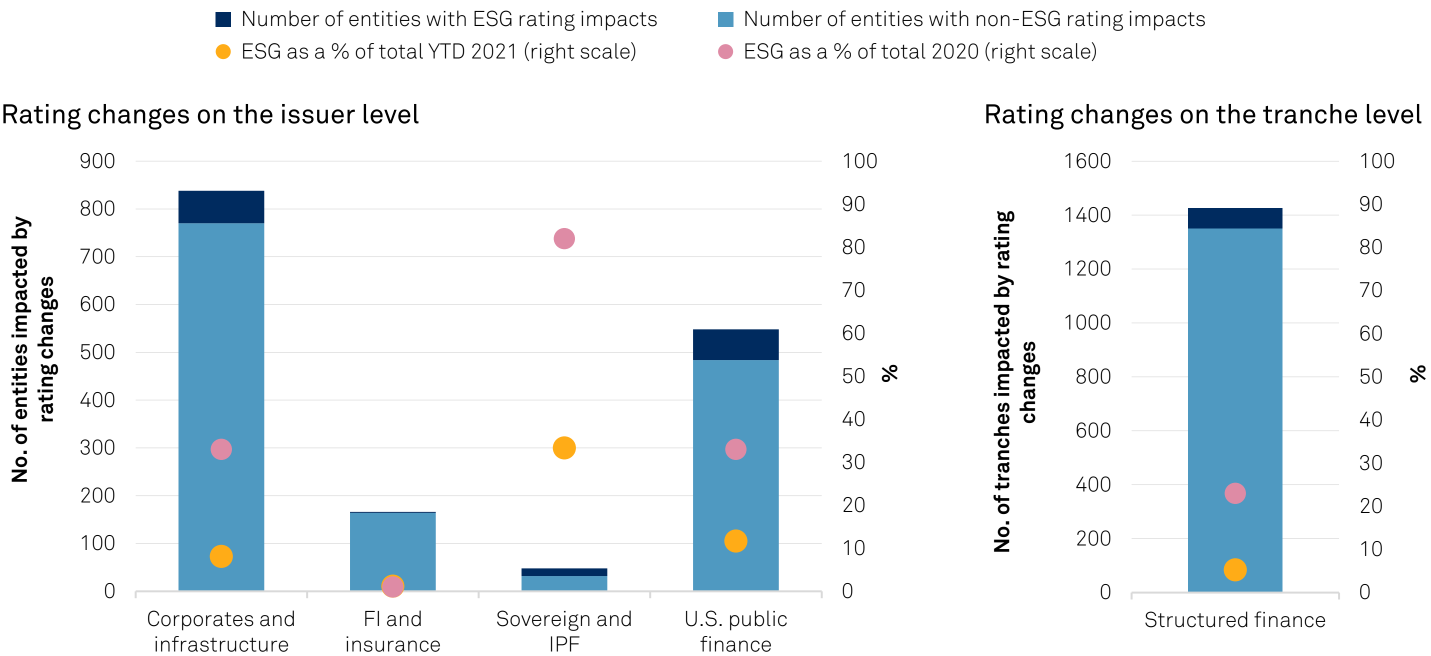
– **Environmental court rulings:** On May 26, the Dutch Hague District Court ordered Shell to reduce its greenhouse gas emissions by 45% by 2030, stating Shell’s timeline was insufficient and that it violated its duty of care law to reduce emissions. Not only does the ruling apply to Shell but it applies to its customers, so also includes scope 3 emissions. The landmark ruling, appealed by Shell, could pave the way for further lawsuits against other global oil and gas producers, as well as other industries that are known heavy polluters. Indeed, there is a similar case against Total Energies pending in France.

– **Shareholder activism:** A majority of Chevron's shareholders recently approved a (nonbinding) proposal to force the company into cutting its carbon emissions, including on the products it sells to its customers. This followed on the heels of a similar victory earlier in the month against ConocoPhillips and Phillips 66. Meanwhile, at ExxonMobil’s annual shareholder meeting, activist hedge funds successfully won two of the 12 board of director seats, and a third seat was decided as of June 2. Shareholders also garnered greater transparency from Exxon on climate change and its role. This underscores the growing sentiment among investors and capital markets toward a future based on renewables rather than fossil fuels. Indeed, it has been reported that the U.S.'s three largest pension funds, NY State Common Retirement Pension Fund, the California State Teachers Retirement System, and the California Public Employees Retirement System have supported the activist’s new board seats. Moreover, some of Exxon’s largest shareholders like State Street, Vanguard, and Blackrock have all been extremely vocal and supportive of net-zero carbon by 2050.

Sectors Overview

Chart 3

ESG Versus Non ESG-Affected Ratings (January-April 2021)



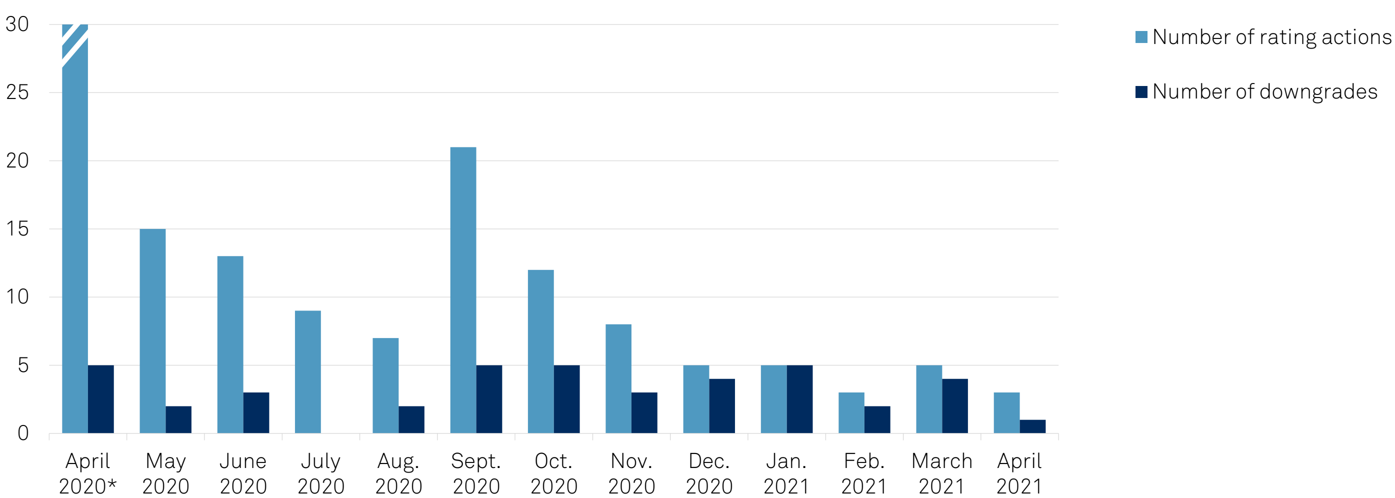
Note: Rating impacts comprise rating, CreditWatch, and outlook changes over January-April 2021. Entities reflect issuers (ultimate parent only without subsidiaries); except for issues/tranches for structured finance. Multiple rating actions are only counted once. Source: S&P Global Ratings.

Sovereigns And International Public Finance

Download table of all ESG-related rating actions

Chart 4

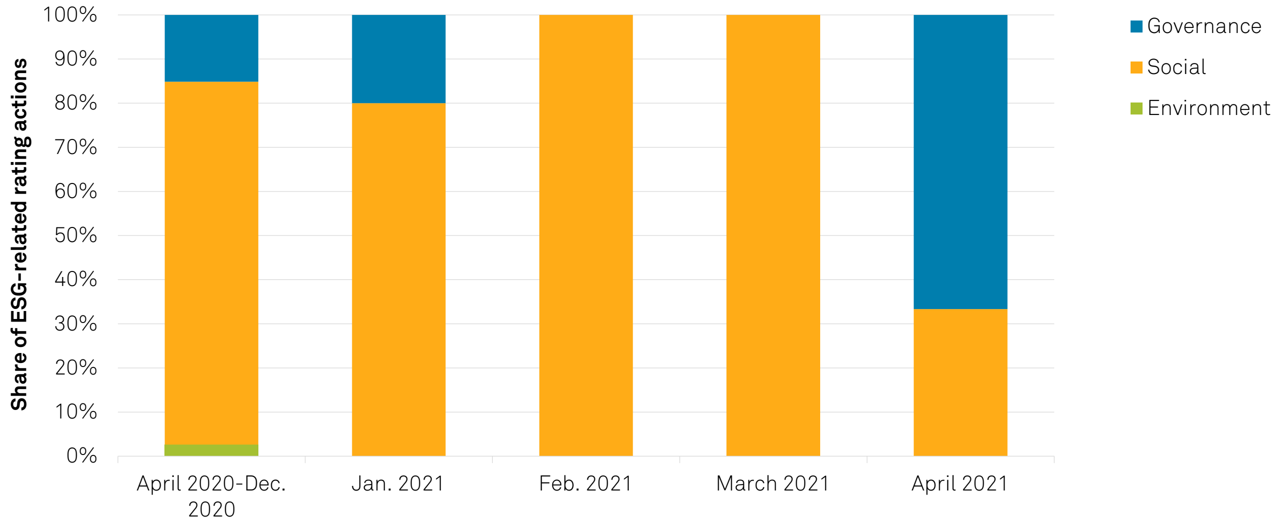
Sovereign And International Public Finance ESG-Related Rating Actions



Note: Rating actions comprise rating, CreditWatch, and outlook changes. *April 2020 rating actions amounted to 43, of which 38 corresponded to negative outlook revisions. Source: S&P Global Ratings.

Chart 5

Sovereign And International Public Finance: ESG-Related Rating Actions By ESG Factor



Source: S&P Global Ratings.

ESG-driven rating activity in the sovereign sector has slowed because we have now incorporated the most severe credit effects of the pandemic into our ratings.

Only one downgrade in April--Morocco to 'BB+'--reflected the fiscal and economic impact of health and safety risks. Meanwhile, our upgrade of Taiwan (to 'AA') was driven by our opinion of its strong governance generally and effective management of the pandemic. We also upgraded Greece (to 'BB') reflecting the country's improved economic and budgetary performance as the adverse impacts of the pandemic have subsided, but also its improved governance effectiveness; we expect policies to accelerate Greece's structural reforms and budgetary consolidation, cementing the downward path of government debt in GDP terms.

Case study: Taiwan. On April 22, 2021, S&P Global Ratings raised its long-term foreign and local currency issuer credit ratings on Taiwan to 'AA' from 'AA-.

Taiwan has demonstrated governance strength through one of the most successful pandemic responses, allowing the government to avoid stringent lockdown measures and attendant economic contraction. The competitive export sector also benefited from the global shift toward remote working and the strong demand for information technology products. These trends enabled the economy to outperform even its pre-pandemic trajectory. Due to years of

a well-managed fiscal position, strong domestic liquidity, and low interest rates, the government's debt-servicing costs have declined substantially. The positive outlook on Taiwan reflects our expectation that these positive trends will continue in the foreseeable future.

Environmental, social, and governance (ESG) credit factors for this credit rating change:

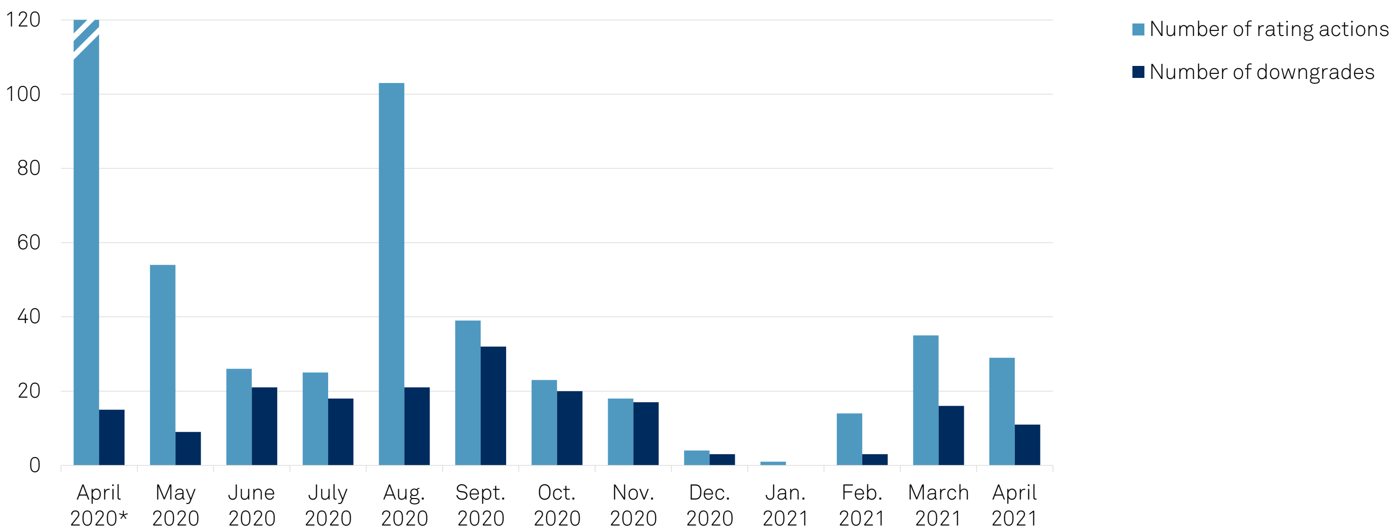
– Governance

U.S. Public Finance

Download table of all ESG-related rating actions

Chart 6

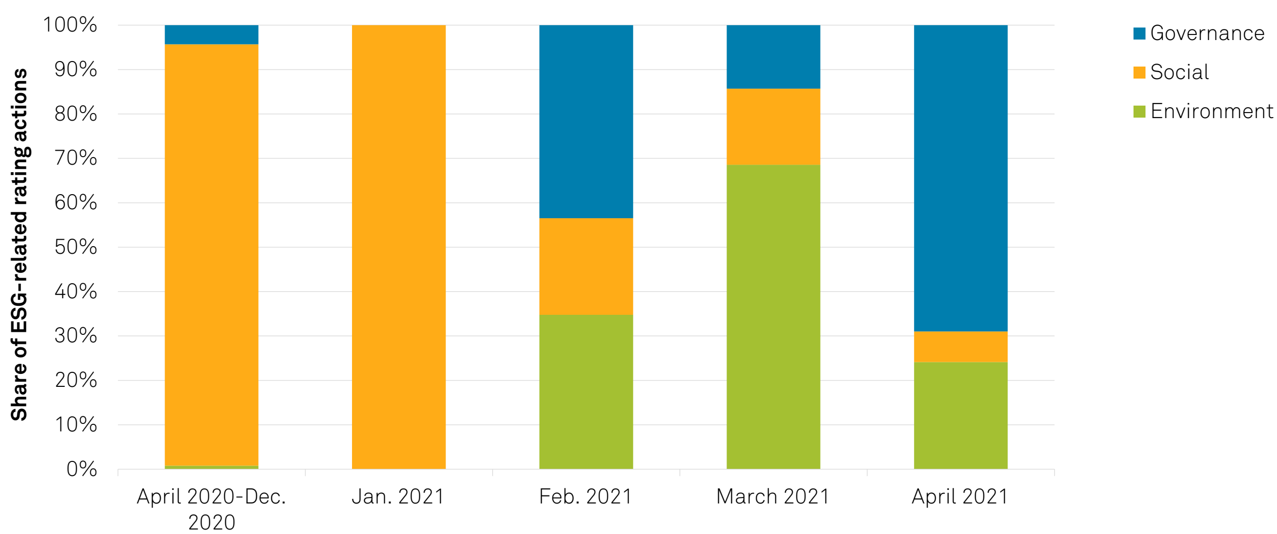
U.S. Public Finance ESG-Related Rating Actions And Downgrades



Note: Rating actions comprise rating, CreditWatch, and outlook changes. *April rating actions amounted to 451, of which 425 corresponded to negative outlook revisions. Source: S&P Global Ratings.

Chart 7

U.S. Public Finance: ESG-Related Rating Actions By ESG Factor



Note: There was only one rating change in January. Source: S&P Global Ratings.

Although ESG-driven rating actions stemming from the pandemic have abated in USPF, with only two in April, pressure lingers on student housing projects in higher education.

Case study: On April 27 and 28, 2021, S&P Global Ratings downgraded Phases II and III of Foundation For Indiana University Of Pennsylvania 2007A bonds To 'B+' and 'B-', respectively, based on larger reserve draws. The outlook for both phases is negative.

The downgrades resulted from lower-than-expected spring occupancy, and uncertainty about whether the project will achieve break-even operations in the fall, given current demand.

Management is projecting operating shortfalls for the project resulting partly from refunds made to students that were advanced by the university in fiscal years 2020 and 2021. Management indicated that the university does not intend to forgive any expenses. Occupancy in fall 2020 was 57%, given the additional pressures of COVID-19, compared with occupancy in the 80% range in fall 2019 and well below break-even occupancy of 77%, according to management. However, with significant enrollment pressure at the university, occupancy was declining prior to fall 2020 and fell to just 44% in the spring 2021.

Environmental, social, and governance (ESG) credit factors for this credit rating change:

- Health and Safety (social)

Case study: On April 9, 2021, we lowered our ratings on Tri-State Generation And Transmission Association Inc. to 'BBB+' From 'A-'; the outlook is stable.

We lowered the ratings to reflect the credit exposures with a recent regulatory filing to the Federal Energy Regulatory Commission (FERC) made by seven of Tri-State's 42-member distribution cooperatives.

The seven cooperatives are requesting that the regulator expeditiously direct Tri-State "to immediately calculate each of the...Complainants' contract termination payments," under the wholesale power purchase contracts obligating the members to purchase their retail customers' energy requirements from Tri-State. Although the members' joint application to FERC does not constitute a notice to terminate the wholesale power contracts expiring in 2050 and early contract terminations are not imminent even if the members prevail, we nevertheless associate heightened credit exposures with the filings because we view them as an expression of dissatisfaction with Tri-State's rates, fuel mix, and/or strategies. We view the members' FERC complaint as an outgrowth of more than a decade of divisiveness that three successive general managers and the board have been unable to conciliate. This level of discord can consume management resources and frustrate strategic planning.

Environmental, social, and governance (ESG) credit factors for this credit rating change:

- Strategy, Execution, and Monitoring (Governance)

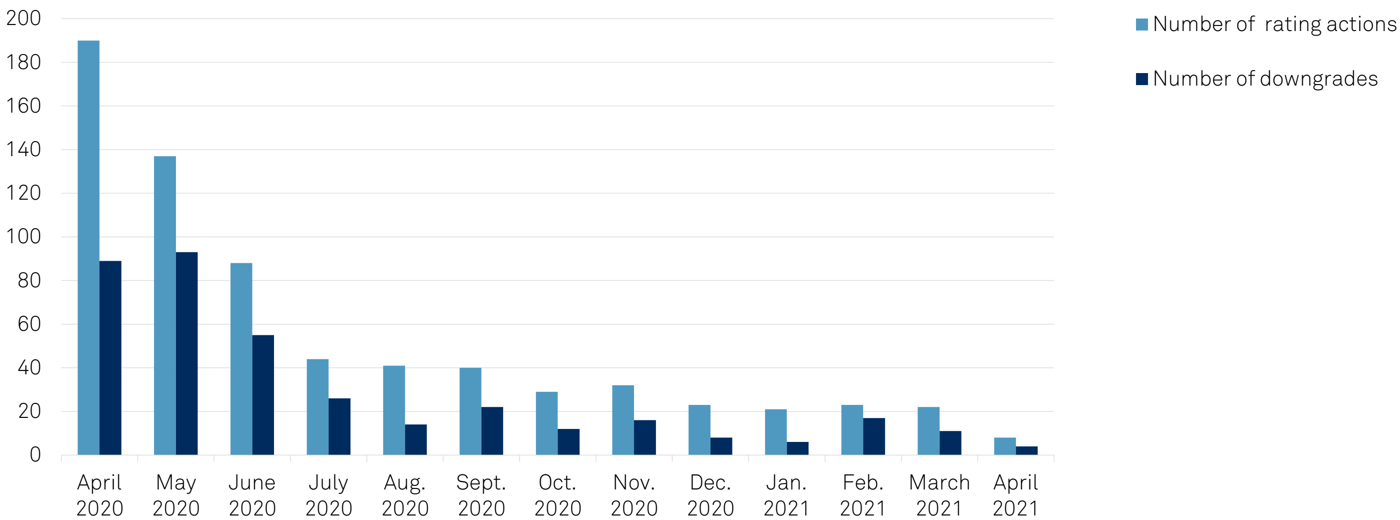
Corporates And Infrastructure

Download table of all ESG-related rating actions

Chart 8

Rating Actions And Downgrades, Monthly Breakdown

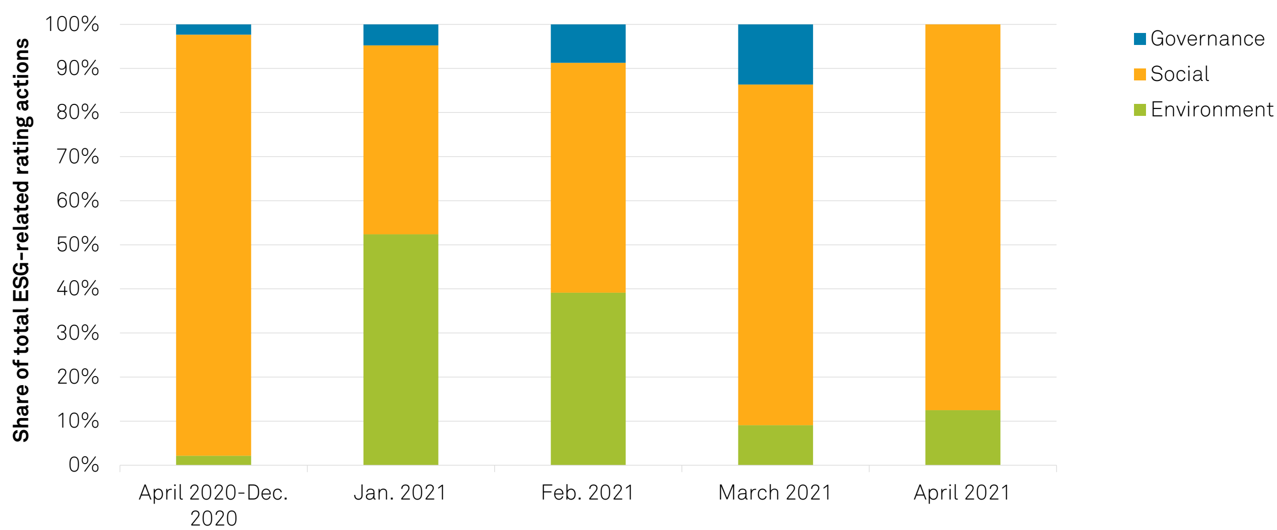
Corporates and infrastructure ESG-related rating actions and downgrades



Note: Rating actions comprise rating, CreditWatch, and outlook changes. Source: S&P Global Ratings.

Chart 9

Corporates And Infrastructure: ESG-Related Rating Actions By ESG Factor



Source: S&P Global Ratings.

ESG-related impacts moderated to eight actions in April (down from above 20 in previous months), of which two were positive.

Although negative actions declined, the majority still relate to health and safety, with prolonged effects on sectors such as restaurants, media and entertainment, leisure and airlines, and airports. On the environmental front, we lowered the rating on Vistra Energy Corp. following its revised $2.1 billion impact from the extraordinary storm that swept Texas in February (up from its previous estimate of $0.9 billion-$1.3 billion).

Case study: Sodexo Downgraded To 'BBB+' On Slower Recovery From COVID Disruption; Outlook Negative, April 7, 2021

The prolonged pandemic-related recovery for France-based food-, maintenance-, and facility-services provider Sodexo triggered the downgrade. In particular we expect to see muted growth for its offices, sports and leisure, and universities services, while its health care and seniors segment has remained largely resilient over the past year, supported primarily by a new contract for rapid testing in the U.K. and improved customer retention in North America.

Environmental, social, and governance (ESG) credit factors for this credit rating change:

- Health and Safety

Case study: Panamanian Airport Tocumen 'BB+' Debt Rating Placed On CreditWatch Negative On Weaker Revenue Prospects, April 23, 2021

Despite the resumption of international flights in October 2020 at Tocumen, monthly traffic levels in the past six months remained on average 30% of the 2019 figure, while we previously expected it to be 40%-60%. Moreover, we believe this trend will continue up to mid-2021, given the current delay in the vaccine distribution program, particularly in South American countries that represent 40% of Tocumen's total flights. Although vaccinations are not mandatory to get on international flights, they reduce the risk of contagion and increase people's willingness to travel abroad. Moreover, we believe the current economic slump and the restrictions and protocols with which travelers will have to comply in order to take international flights also diminish the incentive to travel abroad. Due to the slower traffic recovery, we now expect Tocumen's aeronautical revenue to be 30% lower than our previous expectations

Environmental, social, and governance (ESG) credit factors for this credit rating change:

- Health and Safety

Financial Services

Download table of all ESG-related rating actions

Financial services ratings have experienced very few ESG-related impacts over the past 12 months. We do not treat the pandemic as a social factor for financial services when it relates to the indirect economic credit impact. We have seen the importance of ESG gaining momentum, however, as banks step up to play a critical role in tackling climate change, impact financing, and the standardization of ESG reporting.

In "Environmental, Social, And Governance: How Sustainability-Linked Debt Has Become A New Asset Class," we analyze the growth of sustainability-linked loan issuance, which is expected to approach $150 billion-$200 billion in 2021, up from $120 billion in 2020.

The majority of SLLs issued to date have been in the form of revolving credit facilities. However, a growing number of borrowers are linking sustainability objectives in a term loan format. We see this as a key market trend given that a margin adjustment on a drawn term loan increases the issuer's accountability in meeting its set sustainability performance targets.

Case study: Mexican lending company Alpha Holding Ratings Cut To 'CCC' On Weaker Governance Practices Hitting Solvency And Business Confidence; On Watch Neg, April 23, 2021

In our opinion, the recent announcement related to accounting errors reflects governance deficiencies that would be harmful to Alpha. On April 20, 2021, Alpha announced a restatement to its financial statements for 2018, 2019, and 2020 quarterly results, based on accounting errors. The latter could potentially affect its derivative positions, reserve coverage, account receivables, and capital expenses amortization. In our opinion, we consider the company's internal control environment as deficient based on available evidence, such as past restatements on its financial statements, and the current ones. In addition, we believe this situation will bring reputational damage to the company and will pressure its business stability due the high sensitivity in terms of business confidence to customers and investors.

Environmental, social, and governance (ESG) credit factors for this credit rating change:

- Risk management and internal controls
- Transparency

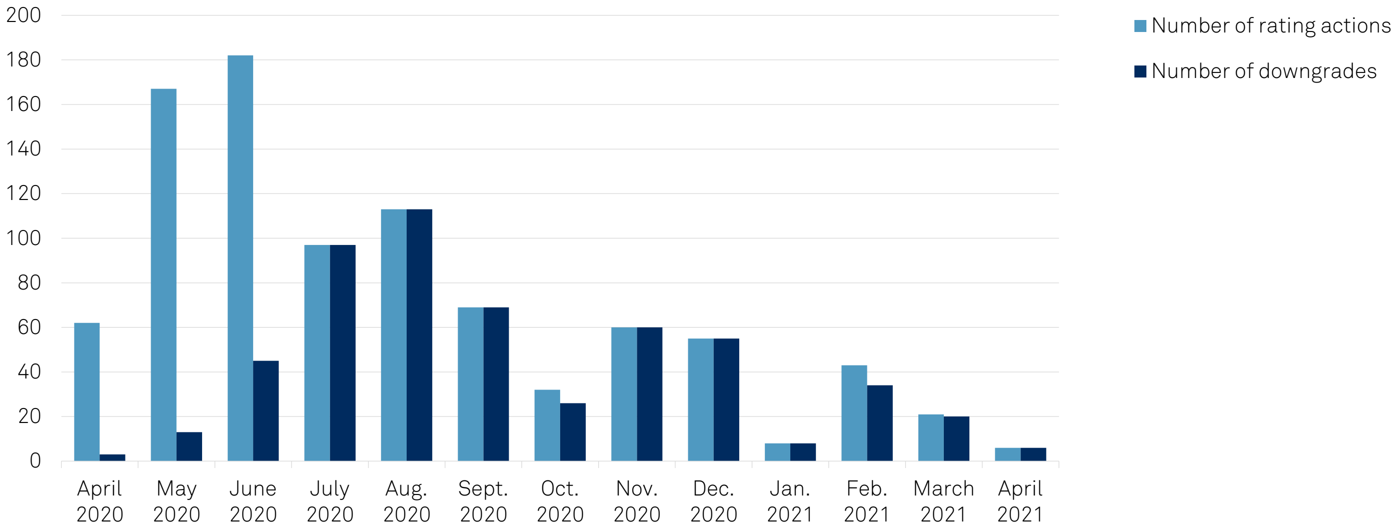
Structured Finance

Download table of all ESG-related rating actions

Chart 10

Rating Actions And Downgrades, Monthly Breakdown

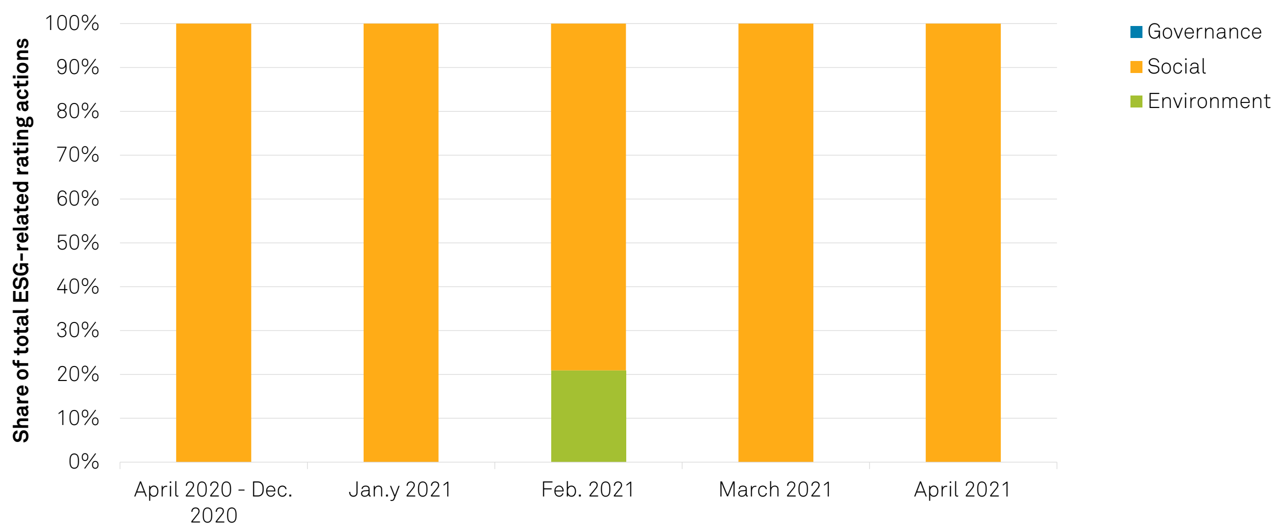
Structured Finance ESG-related rating actions



Note: Rating actions comprise rating, CreditWatch, and outlook changes. Source: S&P Global Ratings.

Chart 11

Structured Finance: ESG-Related Rating Actions By ESG Factor



Source: S&P Global Ratings.

As anticipated, ESG-related rating actions have declined as most of the CreditWatch placements following the spread of COVID-19 have now been resolved. In April, there was only one commercial mortgage backed securities (CMBS) transaction with six tranches where the rating action changes were attributed to ESG credit factors.

Appendix

COVID-19's direct (ESG) versus indirect (non-ESG) impact

We consider the COVID-19 pandemic to be a social credit factor when we believe health concerns and social-distancing measures have a direct impact on an entity's activities. Put differently, our data presented here exclude rating actions stemming from the pandemic-induced recession, and from the downturn in oil and gas that started before the COVID-19 outbreak and is tied to oversupply and a price war. For sovereign ratings, however, we see the pandemic's direct and indirect macroeconomic, fiscal, and external impacts as intertwined and feeding into each other, and therefore consider rating actions triggered by the COVID-19-induced recession as health and safety-related.

We have tagged rating actions tied directly to health and safety concerns as ESG-driven

One of the clearest examples is airlines, for which demand has significantly dropped due to travel restrictions to stop the spread of the virus. Other examples include auto dealers, which were forced to close their doors due to social-distancing requirements, resulting in lost sales for auto manufacturers. Movie theaters, airports, restaurants, and leisure activities were/have been shut down due to the virus and local requirements for social distancing, resulting in a total cessation of revenue streams and limitations on large and social gatherings.

For the purposes of classifying ESG impacts, we excluded indirect rating actions tied to the pandemic-induced recession.

For example, the recession may ultimately increase the risk of nonpayments for banks or depress asset values, affecting insurers. While important, we have not flagged these as ESG-driven. Similarly, many corporate sectors are indirectly affected; for instance, many consumer products companies have had to reduce their advertising, thereby affecting media companies. Also, job losses and loss of consumer confidence have stopped buyers from making large consumer products purchases.

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This report does not constitute a rating action.

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