Healthcare Boards Are Responsible for the "G" in ESG

By Liz Sweeney, Nutshell Associates LLC

Key Board Takeaways

Interest in ESG analysis is explosive among capital markets participants, including rating agencies and institutional investors. According to S&P Global, ESG factors contribute to about a third of credit rating actions on U.S. public finance debt. For these and other reasons, boards should:

- Recognize that ESG represents an admission by credit raters and investors that traditional credit metrics are not sufficient to capture certain factors that influence an organization's long-term success.
- Ensure their organizations are tracking ESG metrics and aligning presentation materials and disclosures to facilitate ESG analysis.
- Use the ESG framework to view the organization's social and environmental stewardship in a new, more holistic way.

The acronym ESG (environmental, social, and governance) was virtually unknown several years ago. Now, ESG is front and center in the lexicon of credit raters, investors, and employers. ESG is a dominant theme at investor conferences. Wall Street banks, mutual funds, and wealth management companies hire ESG analysts and researchers. Rating agencies publish frequently about the importance of ESG factors in credit ratings, with some even publishing formal ESG-themed scores. ESG factors are now cited by S&P Global Ratings as causing about a third of all rating changes for U.S. public finance debt issuers.[1] And within the ESG bucket, governance contributes most frequently to rating changes. According to S&P, in 2017 and 2018, "Governance was the most dominant factor affecting credit quality," accounting for a whopping 67 percent of ESG-related rating actions. Furthermore, most ESG-related rating actions are negative. According to Moody's, ESG considerations often have disproportionate downside credit risk, although the impact is not always negative.[2]

This increased ESG scrutiny, and especially the outsized impact of the "G" raises the imperative for healthcare organizations to understand ESG's expanding role in credit ratings and access to capital, track the metrics that credit raters and investors are following, and align presentation materials and disclosure accordingly. Perhaps more powerfully, boards can use the ESG framework to approach their role holistically, embracing the organization's interaction with stakeholders of all kinds and their impact locally, nationally, and even globally.

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Close Siblings: ESG, Socially Responsible Investing, Impact Investing, Sustainable Investing

According to Moody's, the term ESG "refers to a broad range of qualitative and quantitative considerations that relate to the sustainability of an organization and to the broader impact on society of its businesses, investments, and activities. Examples include a company's carbon footprint, or the accountability of a company's management or a nation's government."[3]

Investors increasingly believe that applying ESG factors to enhance financial analysis of an organization helps identify potential risks and opportunities that traditional approaches don't. ESG is closely related to "social" investing strategies, including socially responsible investing, where investment opportunities are actively excluded or included based on ethical considerations; impact investing, where investments are selected to assist an organization to do something the investor considers positive for society; and sustainable investing, which seeks investment in organizations that combat climate change or environmental destruction and promote corporate responsibility. The various concepts are all aligned with the belief that organizations that behave responsibly to a broad range of stakeholders are also often brands that attract strong customer and employee loyalty, contributing to long-term stability and favorable investor returns.

How Does ESG Influence Credit Ratings?

Each rating agency takes a slightly different approach to evaluating ESG factors in their ratings. For the most part, ESG isn't a separate rating factor that has its own weight or score in the rating

1 "When U.S. Public Finance Ratings Change, ESG Factors Are Often the Reason," S&P Global Ratings, March 28, 2019.
2 "General Principles for Assessing Environmental, Social, and Governance Risks," Moody's Rating Methodology, January 2019.
3 Moody's Rating Methodology, January 2019.

methodology. In fact, if you read S&P, Moody's, and Fitch's non-profit healthcare rating methodologies, you won't find the phrase "environmental, social, and governance" anywhere. This can be rather confusing at first blush. How can ESG be such a sizable rating driver yet have no weight or even mentions in the methodology? The answer is partly about packaging—the rating agencies consider ESG factors to be present throughout the methodology already. Bundling a number of factors under the ESG umbrella doesn't require a change in methodologies. For example, the strength of an organization's strategy and execution is routinely assessed as part of rating analysis. That's not new. What is new is that today, if a rating agency downgrades a hospital due to a failure of strategy and execution, it will likely classify it as an ESG-related downgrade, under "governance."

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ESG Analysis Is Not Just Repackaging

Bundling existing credit factors under the ESG banner theoretically doesn't affect ratings. For example, Fitch Ratings assigns "ESG Relevance Scores" to non-profit hospitals and health systems by assessing five environmental, five social, and four governance factors relevant to the healthcare sector, which are bundled into the ESG Relevance Score.[4] The ESG Relevance Score for a hospital doesn't affect its rating because any impactful elements within the 14 ESG factors are already assessed as part of the application of Fitch's rating methodology.

However, ESG analysis isn't just repackaging. There will likely be real and lasting impact of the increased focus on ESG. For investors, ESG analysis, including rating agency ESG scores, can be used as a screen for socially responsible investing of various kinds. Healthcare organizations that score well on these measures may gain access to a new and rapidly growing group of non-traditional investors whose philosophies are aligned more closely with the organization's mission and values than traditional investors. Additionally, while ESG factors are assessed within existing rating methodologies, the rating agencies' increased focus on ESG is a recognition that traditional measures of credit strength don't go far enough to assess an organization's long-term sustainability. In this way, ESG represents new scrutiny of factors that weren't traditionally part of the analysis. A look at Fitch's list of 14 ESG factors for non-profit healthcare organizations reveals some familiar credit factors, as well as others that haven't traditionally gotten much attention in rating analyses, particularly in the environmental and social categories (see sidebar).

Fitch Ratings general ESG risk elements for not-for-profit hospitals and health systems:

- Environmental elements:
  - Emissions from operations
  - Energy use in operations
  - Water use in operations
  - Management of medical waste
  - Business disruption from climate change/environmental impacts changing human health requirements
- Social elements:
  - Low-income patient access
  - Data privacy/care quality and patient outcomes/controlled substance management/pricing transparency
  - Labor negotiations and employee satisfaction/recruitment and retention of skilled healthcare workers
  - Worker safety and accident prevention
  - Social pressure to contain healthcare spending growth/sensitive political environment with impactful legislative changes
- Governance elements:
  - Strategy development and implementation
  - Board independence and effectiveness/ownership concentration
  - Complexity, transparency, and related party transactions
  - Quality and timing of financial disclosure

Why Governance Is an Outsized Factor

All the rating agencies describe governance as the most common cause of ESG-related rating actions. This is largely because they take an expansive view of governance, encompassing most factors that are in the control of the organization. According to Moody's, "Unlike environmental and social risks, which may be driven by external factors such as regulation or demographic change, governance risks are largely issuer-driven. The impact of weak governance may affect scoring for [factors] influenced by an issuer's actions, planning, and policy decisions, such as a financial policy factor or leverage and coverage metrics."[5] Translation: when they score factors that weigh heavily in ratings such as financial metrics, they don't just assign scores based on number crunching; they also incorporate their view of financial governance into scores, which could mean a worse score than the numbers would otherwise indicate, which in turn can negatively impact the rating. In this manner, "governance" assumes a pervasive role in the application of the rating methodology, even for factors that were not traditionally considered governance-related.

Fitch Ratings also describes governance as the main driver of ESG-related credit impact: "This outcome is not surprising given that such issues as political stability, creditor rights, financial transparency, governance structure, government independence, and control of corruption are important rating considerations."[6]

4 "Introducing ESG Relevance Scores for Public Finance/Infrastructure," Fitch Ratings, May 16, 2019.
5 Moody's Rating Methodology, January 2019.
6 Fitch Ratings, May 16, 2019.

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In a review of recent rating actions, S&P categorized the following reasons as governance-related:[7]

- Failure to prevent money laundering
- Deficiencies in management, governance, and risk management
- Pension pressures
- Covenant breaches
- Oversight of merger and acquisitions
- Failure to post audited financial information

Taken together, it is clear that the "G" in ESG stands for a lot of things.

How Healthcare Boards Can Leverage ESG Concepts

The explosive growth of interest in ESG analysis signals that credit raters and investors believe traditional credit metrics are inadequate to measure long-term creditworthiness in an interconnected world where long-term success is increasingly tied to an organization's behaviors towards its environment, employees, vendors, customers, the local community, and even its role in global phenomenon such as climate change. At a minimum, healthcare organizations should start to collect data and monitor performance on ESG measures, then align disclosure and rating presentations with the ESG frameworks that the rating agencies are using. This will enable constructive two-way conversations about ESG factors, impress the rating analysts, and potentially open the door to new types of investors.

Rather than representing a new reporting burden on healthcare organizations, however, growth in ESG analysis is great news. Non-profit boards have always thought broadly about their role in the local community and the many stakeholders they serve, espousing values of social and environmental stewardship that their corporate brethren have only more recently begun to embrace. Many non-profits have felt frustrated in the past that credit raters and investors are, in their view, excessively focused on financial metrics over long-term sustainability.

For boards, ESG is an opportunity to organize the stakeholder engagement activities they have always espoused with the way capital markets now articulate those activities. Seeing the board's role through the ESG lens represents an opportunity to align the board's thinking about the organization's mission, vision, and strategy in new ways. For example, many boards have traditionally conducted siloed discussions of labor relations, access for underserved communities, data privacy, pricing transparency, and controlling growth in spending. Considering all of these holistically as part of the social mission—the "S" in ESG—may help boards to simplify the discussion and at the same time think about those things in new interconnected ways.

In many ways, capital markets are just catching up with the way non-profits have consistently managed their organizations. Does this mean that metrics like debt leverage and market share do not matter anymore? Of course not. But it does mean that credit raters and investors have opened the door to viewing those metrics with a different lens that incorporates other factors influencing long-term sustainability, and those factors generally are ones that non-profit boards have always embraced. Thinking about the board's role through the ESG lens can be a powerful way to guide the organization's activities and enhance investor relations at the same time.

The Governance Institute thanks Liz Sweeney, President of Nutshell Associates LLC, board member at the University of Maryland Medical System (UMMS), and former Managing Director at S&P Global Ratings, for contributing this article. She can be reached at liz@nutshellassociates.com.

7 S&P Global Ratings, March 28, 2019; "The Role of Environmental, Social, and Governance Rating Factors in Our Analysis," S&P Global Ratings, September 19, 2019.