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The Growing Influence of Environmental, Social, and Governance Investing in Not-for-Profit Healthcare

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Environmental, social, and governance (ESG) investing is emerging as a new consideration for many municipal buy-side investors in their buying and selling strategies. ESG has already become a significant consideration for investors in taxable debt; if its significance continues to grow in tax-exempt municipal debt, not-for-profit health systems will need to develop an ESG strategy.

ESG has been part of the fabric of not-for-profit healthcare for a very long time; ESG is largely a new rubric to describe what health systems have already been doing. With a focus on providing high quality, affordable care to all members of their communities, for example, not-for-profit health systems have long been addressing the social component of ESG. Health systems located in areas prone to natural disasters such as hurricanes, tornadoes, flooding, earthquakes, and wildfires are familiar with environmental concerns as well. ESG can be viewed as a broadening of these issues, expanding social concerns into addressing racial or socioeconomic disparities in health outcomes, for example, or bringing an environmental lens to bear on vendors and the supply chain. In governance, ESG introduces concepts such as the diversity of the board. Figure 1 identifies ESG topics of current interest to investors and rating agencies; these topics will continue to evolve.

We are seeing an increasing number of not-for-profit hospitals and health systems devote more discussion in their debt offering memorandums to ESG. For many, the ESG-related information was usually present in past offering documents, albeit in disparate sections. Now these discussions often are combined in a distinct ESG section (although some topics that all investors expect to see addressed—such as strategies for cybersecurity risk or, in earthquake-prone areas, compliance with seismic standards—may still be treated separately). Hospital leaders must think carefully about their approach in expanding ESG disclosure, however, as discussed in more detail below.

Figure 1: *ESG Topics of Interest to Investors and Rating Agencies*

Environmental Considerations	Social Considerations	Governance Considerations
• Climate-change weather events (hurricanes, rising sea levels, flooding, wildfires) • Business continuity and resiliency plans • Vendor and supplier selection based on environmental goals • Sustainability and recycling efforts • Carbon-emission reduction	• Strategies to recruit and retain a diverse workforce • Aging population and behavioral health needs • Disparities in healthcare outcomes among socioeconomic groups • Social determinants of health data and usage • Responsible production of good and services	• Board and c-suite diversity and selection process • Cyber preparedness and management • Alignment of executive compensation with ESG goals • Effective whistleblowing mechanisms • Leadership role for ESG initiatives

The current state of ESG investing

Interest in ESG investing has grown at a rapid pace. In 2021, Morningstar reported that, as of the end of 2020, net flows into sustainable funds in the U.S. totaled a record $51.1 billion and accounted for almost one-fourth of the overall flow into U.S. funds[1] (Morningstar defines sustainable funds as those that use ESG criteria to evaluate investments or assess their societal impact[2]). This was more than double the amount seen in 2019 ($21.4 billion in net flows) and almost ten times the amount in 2018 ($5.4 billion). S&P Global Ratings anticipates that in 2022, municipal sustainable debt issuance will surpass $60 billion.[3]

Many municipal investors have stated that ESG is of growing importance in their buying decisions; some tax-exempt shops have established "impact funds"—which seek to achieve ESG goals as well as generate financial returns—further supporting the growing role ESG has in the market. Greater ESG disclosure may attract a wider base of investors, which in turn may translate into more favorable pricing of primary market bond offerings over the longer term. We have not yet seen significant basis point savings or "greeniums" in not-for-profit healthcare debt issuance but expect savings will increase if interest continues to grow.

Although interest in ESG is growing, standards for disclosure of ESG-related information are not yet fully developed. Efforts to create these standards are underway: The International Capital Market Association (ICMA), for example, has created definitions and voluntary process guidelines for the issuance of Green Bonds and Social Bonds, and several of the rating agencies have developed scoring systems to assess ESG's impact on credit and assist investors in their analysis of organizations' ESG strategies.

Pros and Cons of Committing to ESG Disclosure

Although ESG is a relatively new phenomenon in tax-exempt municipal debt investing, its concerns have long been at the heart of not-for-profit healthcare, even if not under the new ESG rubric. As health system leaders determine whether to commit their organizations to the collection and disclosure of ESG data, they should weigh these considerations.

Pros	Cons
Demonstrating a commitment to ESG may help workforce recruitment efforts, especially among younger generations.	Disclosure standards are still in a nascent stage and may change over time.
For organizations considering new debt issuance, an ESG commitment may attract a broader pool of investors.	Committing to ESG also will require a commitment of resources to gather and report on ESG data.
Disclosure of ESG data aligns with the mission-driven, community-centered focus of not-for-profit healthcare.	Thus far, there have not been significant savings or "greeniums" from ESG-focused debt issuance in not-for-profit healthcare.
A leadership position on ESG issues may enable the organization to help shape emerging disclosure standards.	Once committed to ESG, it may be difficult to disengage if other priorities emerge.

1 Hale, J.: "A Broken Record: Flows for U.S. Sustainable Funds Again Reach New Heights," *Morningstar*, Jan. 28, 2021.

2 Hale, J.: "What Are Sustainable Funds and How Have They Performed?", *Morningstar*, Jan. 31, 2018.

3 Bredeson, A.: "U.S. Municipal Sustainable Debt Issuance Could Surpass $60 Billion in 2022." S&P Global Ratings, Feb. 10, 2022.

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Some municipal market borrowers have issued ESG-labeled Green or Social Bonds. Most recently, the University of Wisconsin Hospital and Clinics Authority (dba UW Health) issued Revenue Bonds Series 2021B as Green Bonds. These were self-designated Green Bonds with a commitment to energy and sustainability standards in hospital building construction (also known as LEED-certified). UW Health notes that its Green Bond issuance aligns with the four core pillars of the ICMA's Green Bond Principles and it has committed to annual disclosure toward its green initiatives, although failure to do so is not a covenant violation or event of default.[4] Social Bonds must show that the proceeds go toward the most vulnerable populations; we are not aware of a self-designated Social Bond issuance in not-for-profit healthcare to date.

Considerations for health system leaders

Leaders of not-for-profit health systems should, at a minimum, educate their boards on the growing interest in ESG by both investors and the rating agencies. They should also begin conversations with their rating analysts on expectations for ESG-related information in rating meeting presentations.

Given the still nascent state of disclosure standards for ESG-related information, health system leaders may want to take a measured approach to more robust ESG disclosures. If they are considering a new debt issuance, they should monitor the extent to which ESG is influencing investor decisions and work closely with their financial advisors and debt counsel in determining the content of any ESG disclosures and, especially, any commitment to ongoing disclosures. They should also assess their ability and resources to regularly collect and report on ESG data before committing to do so.

A commitment to ESG may have additional benefits; "pro and con" considerations for ESG disclosure are provided in the sidebar. For the moment, decisions about ESG are largely within the control of health system leaders. ESG is an issue, however, that should be on their watch list, and that may well evolve into an expectation their organizations will need to meet.

[4] University of Wisconsin Hospitals and Clinics Authority (msrb.org)