How Does ESG Investing in Financials Evolve After the Covid-19 Crisis?

Authored by Mark Kehoe, CFA, Director and Senior Analyst, Global Fixed Income Team

The financial sector’s ability to manage risk during Covid-19 crisis is encouraging: from banks’ expanding role in the recovery, to a large US bank’s $1bn senior unsecured bond to help finance parts of the healthcare industry, and a large European Bank’s Additional Tier 1 green bond to fund green initiatives.

Fundamental effects of the Covid-19 crisis are that employee well-being and workforce diversity will likely garner more attention from investors; and financial sector investors’ understanding of ESG will expand.

Pre-Covid-19 management teams were aware of ESG, but post-Covid-19, management teams will likely be pushed to detail more robust and resilient risk management frameworks.

One of the most important outcomes of the Covid-19 crisis is that investors are now more conscious of the importance of incorporating non-standard risks into their investment framework. Financial investors are also expanding their understanding of ESG risk factors. Banks are now partly playing an essential role in the authorities’ efforts to stabilize the financial markets and support economic recovery. The sector’s current expanded involvement in the recovery solution reflects the regulators’ efforts to significantly strengthen capital and liquidity levels not seen since the great financial crisis of 2008-2009, as well as improved bank governance and risk management. Certainly, the stability of banks during this moment should be contrasted with the fragility of some industrial companies where broken supply chains froze their operations, and others where workers were recalled to plants even when the workers were ill with Covid-19.

In this crisis, the role of central banks has changed. Their expanded role will have a direct consequence on how banks govern and manage themselves in the future. Central banks have now become market makers of the last resort, a step beyond their traditional role as lenders of last resort. Post-crisis, long-term consequences are that banks will be forced to examine whether their liquidity resources are sufficiently resilient to handle market stress when central bank assistance may not be forthcoming.

US bank governance is also being tested from several other angles that will impact investors’ perception of how well banks are managed. First, the Federal Reserve recently instructed the large US banks to suspend stock repurchases and not to increase dividend payouts (Figure 1) as part the annual stress test. Before the results of the test were published, the banks had voluntarily suspended stock repurchases but had not reduced their dividends. Depending on the depth of this crisis, investors may need to revisit these decisions and assess how well banks’ boards of directors are managing capital retention. Without proper stewardship, the risk is that regulators may become more important in determining how bank capital is allocated.

FIGURE 1: TOTAL CAPITAL PAYOUT RATIOS (%)

- Wells Fargo
- Citibank
- Bank of America
- JP Morgan

Line Signifies 100% earnings payout
Second, in this crisis, banks are more proactive in offering customers loan forbearance plans. We see this as a positive move toward stakeholder capitalism. It also helped break the mechanical linkage between a sudden increase in bad loans (Figure 2) and the need to raise capital. This has ensured banks remain optically solvent. How well banks manage the process of moving deferred loans back to performing status will be critical to maintaining confidence in balance sheets as well as allowing customers sufficient time to economically recover. Every crisis has a fundamental effect of changing the allocation of resources among stakeholders. This crisis is no exception. Equality and employees’ well-being are likely to garner more attention from investors. In a sense, we will view a broader definition of the Social factor in ESG. In this crisis, we learned the concept of essential worker is very different than the traditional view of “key-man risk” and the importance of workforce diversity has become ever more apparent. These concepts are applicable to banks as well as non-financial companies.

To date, we are encouraged by the financial sectors’ actions and its ability to manage risk. In May 2020, a large US bank issued $1bn of a senior unsecured bond to help finance parts of the healthcare industry dealing with Covid-19. More recently, a large European bank issued an innovative Additional Tier 1 green bond to help fund green initiatives, though we are circumspect around how such capital can be ring-fenced to fund green assets.

One area of the non-bank financial world where further attention may be expected is the role of the credit rating agencies. Focus will likely remain on their actions around corporate credit rating downgrades and the use of credit ratings by the central banks as a screen to purchase corporate bonds. For financials specifically, this impacts the insurance sector given its reliance on credit ratings as part of its risk management framework within in its investment portfolios.

In sum, this crisis has helped push forward and expand financial sector investors’ understanding of ESG and the importance of including non-standard, difficult to measure factors into their risk assessments. The financial sector has responded well so far but greater disclosure around broader risk factors should further help investors differentiate among companies’ responses and future strategies.
1. Issue or security names cited herein are for informational purposes only to illustrate current factual events in the financial sector. Nothing contained in this publication shall be construed as a recommendation to invest in or include issuers or securities in any investable universes and/or portfolios. Companies or securities identified herein do not necessarily represent past or current holdings of MacKay Shields funds or strategies. Issuers or securities cited are not intended nor should it be construed to be a recommendation to buy or sell any individual security. Issuer names or securities should not be considered predictive of future transactions or commitments made by MacKay Shields LLC nor as an indication of current or future profitability.

IMPORTANT DISCLOSURES

Availability of this document and products and services provided by MacKay Shields LLC may be limited by applicable laws and regulations in certain jurisdictions and this document is provided only for persons to whom this document and the products and services of MacKay Shields LLC may otherwise lawfully be issued or made available. None of the products and services provided by MacKay Shields LLC are offered to any person in any jurisdiction where such offering would be contrary to local law or regulation. It does not constitute investment advice and should not be construed as an offer to buy securities. The contents of this document have not been reviewed by any regulatory authority in any jurisdiction.

This material contains the opinions of the Global Fixed Income team but not necessarily those of MacKay Shields LLC. The opinions expressed herein are subject to change without notice. This material is distributed for informational purposes only. Forecasts, estimates, and opinions contained herein should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Any forward-looking statements speak only as of the date they are made and MacKay Shields assumes no duty and does not undertake to update forward-looking statements. No part of this document may be reproduced in any form, or referred to in any other publication, without express written permission of MacKay Shields LLC. ©2020, MacKay Shields LLC. All Rights Reserved.

Note to European Investors: This document is intended for the use of professional and qualifying investors (as defined in the Alternative Investment Fund Manager’s Directive) only. Where applicable, this document has been issued by MacKay Shields UK LLP, 200 Aldersgate Street, 13th Floor, London EC1A 4HD, which is authorized and regulated by the UK Financial Conduct Authority (FRN594166) and/or MacKay Shields Europe Investment Management Limited, Hamilton House, 28 Fitzwilliam Place, Dublin 2 Ireland, which is authorized and regulated by the Central Bank of Ireland.