Assessing ESG risks in the GCC

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Environmental, social, and governance (ESG) factors are under ever-increasing scrutiny as investors and companies globally become more socially and environmentally conscious and the potential financial benefits are gradually understood. For example, an increasing number of companies with strong ESG performance have reduced costs, improved worker productivity, mitigated risk, and created new revenue-generating opportunities.

The assessment of companies' ESG performance, however, will inevitably look very different across regions. The heavily fossil fuel-reliant economies of the Gulf Cooperation Council (GCC), for instance, present unique ESG risks and opportunities for those operating and investing in the region.

Where material and visible, such risks and opportunities can impact the creditworthiness of entities. At S&P Global Ratings, we incorporate ESG factors into our credit ratings if our analysts believe that they will impact the entity's ability and willingness to meet its financial commitments either positively or negatively.

A financial concern

One of the most comprehensive empirical studies on ESG and financial performance conducted by Gunnar Friede, Timo Busch & Alexander Bassen, which aggregates the findings from nearly all academic review studies between 1970 and 2014, found a positive ESG-Corporate Financial Performance relation (ESG-CFP) in almost 63% of meta studies.

But ESG factors can have negative, as well as positive, impacts on a company's finances – and in turn, its creditworthiness. The influence may be reflected through a change in the size and relative stability of an obligor's current or projected revenue base, its operating requirements, its profitability or earnings, its cash flows or liquidity, or the size and maturity of its financial commitments.

Although true across the board, this may be particularly pertinent for the GCC, whose economies primarily rely on one of the sectors most exposed to ESG-related risk and disruption: oil and gas.

Environmental risks for oil-fuelled economies

The GCC's dependence on oil and gas means it is particularly exposed to environmental risks, especially in relation to greenhouse gas (GHG) emissions. In 2017, GCC countries alone generated an estimated 1.5 billion tons of absolute GHG emissions. In fact, on a per capita basis, GCC GHG emissions are among the highest globally. The second, perhaps more significant risk, is the pace of the energy transition away from carbon-based fuels, which could result in strong deviations from industry demand forecasts.

For regions such as the GCC and Iraq, where, on average, hydrocarbons comprise 81% of central government revenues, this poses a substantial risk as shifting investor appetite continues to drive down the price of oil. We ran a hypothetical stress test of oil prices gradually declining to below US$40 by 2030, and the results indicated that without additional policy response, the average rating of Gulf sovereigns could fall by two notches.

However, with less stringent environmental legislation and lower production costs in the GCC than in Europe or North America, local firms are under less time pressure to adjust to changing global energy demands. This consequently provides sovereigns with some resilience to energy transition risk, helping to buy time for economic diversification before the headroom on their credit ratings are negatively impacted.

The region may see select renewable energy projects as compelling opportunities for portfolio diversification. This is true especially for solar, due to the very high solar radiation levels and a large number of sunlight hours in the GCC throughout the year – two factors crucial for efficient and economically viable solar electricity generation. According to the International Renewable Energy Association, almost 60% of the GCC's land surface area has "excellent" suitability for solar photovoltaic deployment.

Regional engagement with renewables is already visible. Saudi Arabia's government, for example, recently announced an ambitious renewables target to deliver 58.7 gigawatts of clean energy. This would not only help diversification of energy sources but reduce the self-consumption of fuel by the country.

Governance risks in the GCC

In several countries across the region, such as the UAE, still-developing political institutions, centralized decision-making processes, and some weaknesses in transparency can present governance risk exposure.

For a GCC based insurer, governance deficiencies have resulted in a direct impact on credit ratings. An audit indicating financial reporting deficiencies and increased liquidity and capital adequacy risks in 2018 resulted in a rating downgrade to B from BB.

However, we believe that this risk can be mitigated. Indeed, Abu Dhabi Commercial Bank's strategic choices and sound business development has not been negatively impacted by its ownership structure. First Abu Dhabi Bank has similarly managed to mitigate this risk with its high-quality management team with a solid track record, stability in senior roles, and strong disclosure practices compared with local and regional companies.

An upper hand

Interestingly, the GCC has historically been accustomed to incorporating social factors into business and investment strategy. Within Islamic finance, there are a range of reportedly substantial socially responsible products which can help entities hedge their social risk exposure. In particular, Qard Hassan, consisting of a loan granted for welfare purposes or to bridge short-term funding requirements where the borrower is required to pay only the principal; Zakat, similar to a tax levied on wealth that exceeds a certain threshold and is used for social welfare purposes without expectation of repayment or remuneration; and Waqf, a donation of an asset or cash for religious or charitable purposes with no intention of reclaim.

We also see similarities between the social focus of ESG analysis and the Sharia principle of profit- and loss-sharing, both of which ultimately aim to adopt a stakeholder view and increase social cohesion to ensure that no member of society is left behind.

The strong presence of Islamic finance in the GCC may give companies in the region a unique pathway in the transition towards adopting other ESG objectives. There are certain parallels, for instance, between the Sharia principles that underpin Islamic finance and the objectives of sustainable finance. The Sharia “protection of life” principle, for example, aligns with the environmental element of ESG, where both emphasize refraining from developing or financing operations that harm the environment or the wellbeing of humankind.

On the governance side, Islamic banks and instruments are typically subject to an additional layer of governance compared with their conventional counterparts, and are typically approved by Sharia boards, which can ensure the conformity of these products with Sharia at any point during their life cycle. Finally, Sharia-compliant investing, like ESG-linked issuance, requires tracking of proceed allocation to eligible projects.

Islamic finance instruments are being harnessed to explicitly support the achievement of environmental objectives, too. Green sukuk, which are to some extent the Sharia-compliant equivalent of green bonds, are poised for significant future growth as core Islamic finance countries such as the UAE and Saudi Arabia look to shift to greener energy sources.

As such, we believe that Sharia principles and Islamic finance can contribute to the financings of green and social infrastructure needed for the transition to a low carbon economy.

Yet to be effective, we believe that these vehicles would benefit from robust governance frameworks and standardized interpretation of Sharia principles that are currently lacking to make a difference when it comes to effectively directing capital towards achieving ESG objectives.

Therefore, we believe that not only is there scope to mitigate the unique environmental and governance risks that the region faces – largely due to fossil fuel reliance and still-developing governance frameworks – but we may also see creditworthiness improve for companies that proactively adopt sustainable practices and capitalize on the investor demand for more ESG-conscious financing strategies.