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INSIGHTS

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RATING THE RATERS ON ESG

What credit rating agencies should be doing to better integrate environmental, social and governance (ESG) factors into credit rating assessments.

As an active long-term investor, we have a responsibility to our clients to try to safeguard their interests by advocating for the effective, efficient and reliable operations of the capital markets in which we invest. Working with market infrastructure providers like stock exchanges, data providers and credit rating agencies can help establish formal and informal standards and practices that will enhance the integrity of market operations. An important part of this engagement is identifying how such market infrastructure providers can encourage greater disclosure of material environmental, social and governance (ESG) data by issuers.

As we have previously written (see "Let's Give Credit to ESG"), ESG characteristics are drivers of risk and opportunity for both fixed income and equity investors, but it is important to note that the ESG data required to assess a bond is often different than the ESG data required to assess a stock. Fixed income investors, therefore, need to advocate for broader disclosure of ESG data that is specifically relevant to their security valuation and portfolio construction processes, and should particularly engage with credit rating agencies given the impact they may have on disclosure standards.

Acting on this need, we have been collaborating with the UN-supported Principles for Responsible Investment (PRI) since 2015 to encourage credit rating agencies to more systematically incorporate ESG characteristics into their issuer ratings.[1] Our fixed income analysts have met with credit rating agencies across our offices in the Hague, London, Chicago and Tokyo. Most recently, we hosted a roundtable with the PRI at our global headquarters in New York to enable a dozen asset managers to provide specific guidance and feedback to Standard & Poor's (S&P) and Moody's.

In recent years, some credit rating agencies have been taking steps to more robustly consider ESG risks in their credit risk assessments. In 2012, S&P introduced references to the management of environmental and social risks and the oversight of these risks by a company's board of directors in the Management and Governance section of its credit rating methodology.[2] S&P says it can point to 106 examples over the last two years where environmental and climate concerns—both event-driven and those occurring over a longer time horizon—resulted in a change of rating, outlook or CreditWatch action.[3] S&P states that in 44% of these cases there was a positive rerating, and in 56% a negative rerating.

[1] *ESG in Credit Ratings Initiative.* United Nations Principles for Responsible Investment: https://www.unpri.org/about/pri-teams/investment-practices/esg-in-credit-ratings-initiative, 2015.

[2] *Proposal For Environmental, Social, And Governance (ESG) Assessments.* S&P Global Market Intelligence: https://www.globalcreditportal.com/ratingsdirect/renderArticle.do?articleId=1705169&SctArtId=399709&from=CM&nsl_code=LIME&sourceObjectId=9783018&sourceRevId=2&fee_ind=N&exp_date=20260906-19:11:59, September 2016.

[3] Williams J and Wilkins M. *How Environmental and Climate Risks and Opportunities Factor Into Global Corporate Ratings - An Update.* S&P Global: https://www.spglobal.com/our-insights/How-Environmental-And-Climate-Risks-and-Opportunities-Factor-Into-Global-Corporate-Ratings---An-Update.html, November 2017.

Moody's clarified its approach to integrating ESG into its rating methodology in 2015, saying that it reflects ESG considerations in its holistic assessment of credit risk through scored and non-scored factors, with a particular focus on 14 sectors with high or very high carbon transition risk (e.g., coal, oil and gas, building materials, steel, utilities and airlines).[4]

In contrast, while Fitch has stated in recent weeks that it also considers ESG risk in its credit ratings, it added that "it is rare for ESG risk to be the main driver of credit risk or a rating action"[5] and has not yet provided a quantitative review of ratings decisions comparable to the work completed by S&P. Fitch has not signed on to the PRI's Credit Rating Initiative and did not send a representative to our roundtable.

We feel much more needs to be done. We say this not because our fixed income analysts rely on the ratings provided by the credit rating agencies—our analysts develop their own internal rating of an issuer based on business quality, management quality and ESG considerations—but because of the role that the agencies play in establishing de facto standards for disclosure by issuers. We call on credit rating agencies to take the following four steps:

9,000 research updates reviewed by S&P[3]

717 cases where environmental and climate factors were important to the analysis[3]

106 cases where environmental and climate concerns resulted in a change of rating, outlook or CreditWatch action[3]

1. **Develop and disclose systematic methodologies for assessing material ESG considerations at the industry level.** We have yet to see a credit rating agency publish a transparent and detailed methodology for analyzing ESG considerations as part of their credit analysis methodology across industries. Investors and issuers need clarity on what factors credit analysts specifically review for each industry and we believe that analysts should use a common investor-oriented framework like the Sustainability Accounting Standards Board (SASB) as the starting point for their work.[6] We believe methodologies should consider ESG-related risks to repayment, and the capability and willingness of management and the board to take adaptive actions in response to ESG-related risks and opportunities. Although S&P proposes to include this information as a separate assessment or product, we believe the assessment of ESG factors should be found within the credit rating analysis.[2]

2. **Provide transparency on how ESG considerations affected the credit rating review of each issuer.** We recognize that not every factor identified as material at the industry level will be a material determinant of the credit rating of a given issuer; well-capitalized issuers with healthy cash flow may be able to compensate in the near term for ESG concerns. However as investors we want to understand how the analyst reached their conclusion and what influence ESG considerations did or did not play.

3. **Name issuers who are not providing sufficient disclosure of material ESG topics.** Issuers pay for credit rating agency services and seek a rating that positively reflects their strengths in the hope that this will reasonably minimize their cost of capital. This puts credit rating agencies in a position of influence to request disclosure of material ESG data, ideally to the market as a whole. This is particularly important for smaller or privately held issuers who may not be subject to such pressures from equity investors. Where issuers are unwilling to disclose ESG data publicly, a credit rating agency's position as an insider uniquely positions it to assess management and the board's commitment to addressing material ESG risks and opportunities, and provide high-level qualitative conclusions in its rating report. Where issuers are unwilling to provide or engage on material ESG topics, a credit rating agency should report this fact. Understanding that a management team has been unwilling to provide disclosure is an important consideration in assessing broader management quality and governance. It may also be an impetus for investors to engage directly with management.

[4] *Incorporating environmental, social and governance risks into credit analysis.* Moody's Investors Service: https://www.moodys.com/research/Moodys-Incorporating-environmental-social-and-governance-risks-into-credit-analysis--PR_334072, September 2015 and *Moody's Approach to Assessing ESG in Credit Analysis.* Moody's Investors Service: https://www.moodys.com/sites/products/ProductAttachments/ESG-considerations-on-credit-analysis.pdf?WT.z_referringsource=TB~ESGhub~ESGconsiderations, 2017.

[5] Insoll M and Griffiths A. *Fitch Outlines Approach to Capturing ESG Risk in Credit Ratings.* Fitch Ratings: https://www.fitchratings.com/site/pr/1031934, November 2017.

[6] Sustainability Accounting Standards Board: www.sasb.org, 2017.

4. **Proactively identify and highlight systematic ESG risks that require greater attention by issuers and investors.** We believe that credit rating agencies are well positioned to look at industries and markets holistically across the credit spectrum, and to highlight emerging and systematic risks that may be increasing in materiality. Through the use of scenario analysis and stress testing, a rating agency can help identify the potential impact of these risks, and create frameworks for enhanced disclosure by issuers. A good example of early practice is the public support that both S&P and Moody's have given to implementing the scenario analysis around climate-related risks and opportunities recommended by the Taskforce on Climate Related Financial Disclosure (TCFD).[7]

"ESG-related disclosures in the Non-Investment Grade Credit markets will need to improve over time, and we think the rating agencies can play an important role in this process."

- **CHRIS KOCINSKI**, DIRECTOR OF NON-INVESTMENT GRADE RESEARCH

"We need transparency and consistency in the way that credit rating agencies review material environmental, social and governance characteristics at the industry level. As credit analysts, we will always go beyond this and do our own fundamental research, but it is important that issuers and investors know what is driving the ratings."

- **STEVE FLAHERTY**, DIRECTOR OF INVESTMENT GRADE RESEARCH

"ESG factors are important to the analysis of sovereign and corporate credit in emerging markets and we believe that credit ratings agencies can facilitate improved disclosure from issuers while also providing a systematic framework for investors to better understand the impact of ESG risks on agencies' assessment of overall credit risk."

- **KAAN NAZLI**, SENIOR ECONOMIST EMERGING MARKETS DEBT

By taking these steps, credit rating agencies can help well-managed issuers with strong ESG performance differentiate themselves from their less well-managed industry peers. Academic research suggests this may be associated with lower direct borrowing costs as well as lower stock price synchronicity, which is associated with lower cost of capital for issuers overall.[8]

More importantly, this sort of action will also help support the effective, efficient and reliable operations of the capital markets as a whole by reducing systematic risk and improving capital allocation. We look forward to continuing to work with our partners at the PRI to engage with credit rating agencies on this important issue.

[7] *Statement of Support and Supporting Companies.* Task Force on Climate-Related Financial Disclosures: https://www.fsb-tcfd.org/statement-support-supporting-companies-june-2017/, June 2017.

[8] Bauer, Rob and Hann, Daniel, *Corporate Environmental Management and Credit Risk*. SSRN: https://ssrn.com/abstract=1660470 or http://dx.doi.org/10.2139/ssrn.1660470, December 2010. Grewal, Jyothika and Hauptmann, Clarissa and Serafeim, George, *Material Sustainability Information and Stock Price Informativeness.* Harvard Business School Working Paper. SSRN: https://ssrn.com/abstract=2966144 or http://dx.doi.org/10.2139/ssrn.2966144, June 2017.

For more information about Neuberger Berman's approach to ESG investing, please visit **www.nb.com/esg**

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