ESG IN CREDIT RISK AND RATINGS

BROADENING THE OUTREACH TO ESG INFORMATION PROVIDERS

The ESG in Credit Risk and Ratings Initiative is funded by the Gordon and Betty Moore Foundation through the Finance Hub, which was created to advance sustainable finance.

RESULTS FROM A SURVEY FOR FIXED INCOME INVESTORS

Investors utilise a range of data and information to make investment decisions. In addition to traditional financial metrics, there is an increasing consensus that integrating environmental, social and governance (ESG) factors in analyses provides investors with a more holistic view and leads to better-informed investments.

While investors may access data directly from issuers and other stakeholders such as industry associations or regulators, many also subscribe to ESG information providers. The term is used here to refer to third-party providers of ESG data, services, opinions and/or ratings[1]. Some focus on issuers (corporate, sovereign or sub-sovereign); some are sectoral or issue focused; and some provide tools that facilitate ESG portfolio analytics (e.g. carbon footprint, impact investing). Their products and services can be utilised by different stakeholders and the methodologies, nature and scope of the data inputs may vary. However, they all share the same ESG or sustainability focus.

Given that responsible investment approaches originally developed in equity investing, it is not surprising that for commercial reasons, many ESG information providers have prioritised issuer coverage and tools which suit equity investors. With the adoption of responsible investment expanding to other asset classes, such providers are also being utilised by fixed income investors.

As a result, the PRI's ESG in Credit Risk and Ratings Initiative launched a survey for fixed income investors to gain insights on their use of these services and their views on the quality and usefulness of such information.

Since the initiative was launched in 2016, the PRI has nurtured a dialogue between the credit analysts of asset managers, asset owners and credit rating agencies (CRAs). This year, the initiative is broadening its outreach to other stakeholders, including ESG information providers, who play a key role in aggregating and analysing data from issuers. Through this work, we aim to clarify the distinction between the incorporation of ESG factors in credit ratings and the evaluations offered by ESG information providers. To this end, the survey also included questions to assess investors' understanding of how CRAs integrate ESG factors in their analysis, and if this has improved since the start of the initiative.

This note summarises the responses to the survey, which was structured as follows:

1. Usage of ESG information providers by fixed income investors
2. Process for provider selection
3. Satisfaction with product coverage and data collection
4. Data quality and methodology transparency
5. Methodology suitability for fixed income investment
6. The difference between ESG integration in credit ratings and ESG evaluations

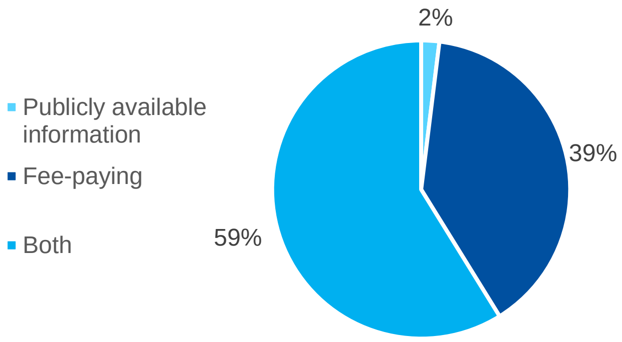
The survey was conducted between 10 March and 29 May 2020. We received responses from 59 PRI investor signatories, of which 60% have more than half of their assets under management invested in fixed income assets.

Where appropriate, we have provided commentary alongside the charts. Certain questions were qualitative and therefore the results are not accompanied by a chart.

[1] These are commonly known as ESG ratings but to avoid confusion between these and credit ratings we refer to them as evaluations throughout this note.

1. USAGE OF ESG INFORMATION PROVIDERS BY FIXED INCOME INVESTORS

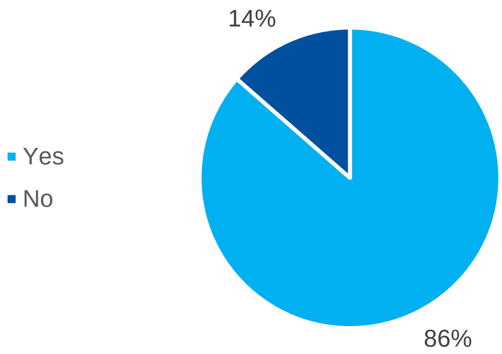
Figure 1. Fixed income investors use a mix of fee-paying and publicly available information



Survey participants stated that they use a mix of fee-paying and publicly available information, or only use ESG data that they need to pay for.

Question: What type of ESG data/analysis do you use?

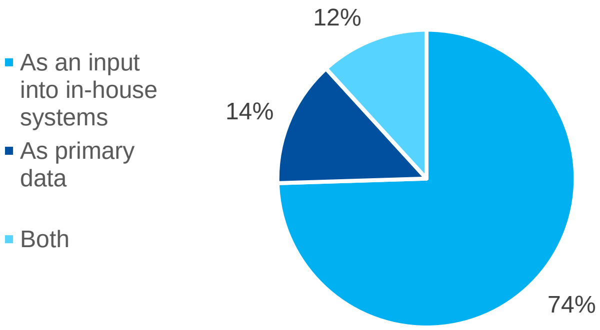
Figure 2. Most fixed income investors use third-party ESG information providers



Fixed income investors rely heavily on ESG information providers, as more than three-quarters of respondents indicated that they use their services.

Question: Do you use ESG data/analysis/services produced by third-party providers?

Figure 3. Investors use third-party ESG resources as an input for further analysis using proprietary systems

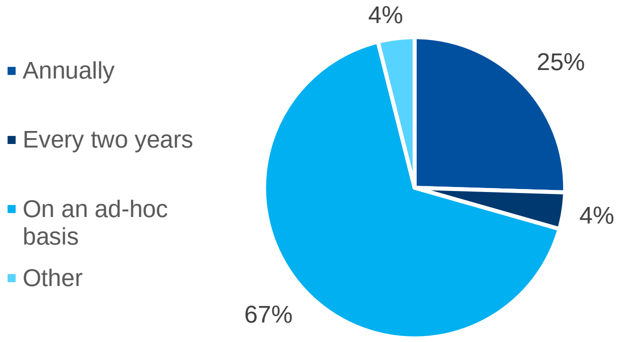


The role and the significance that ESG information plays in fixed income responsible investment processes is high: more than three-quarters of respondents use third-party ESG resources as an input into their in-house proprietary ESG toolkits, as opposed to using them as primary ESG data without conducting internal analysis. This suggests that most investors have built their own in-house ESG research and analytical systems.

Question: How are you using third-party ESG resources in fixed income?

2. PROCESS FOR PROVIDER SELECTION

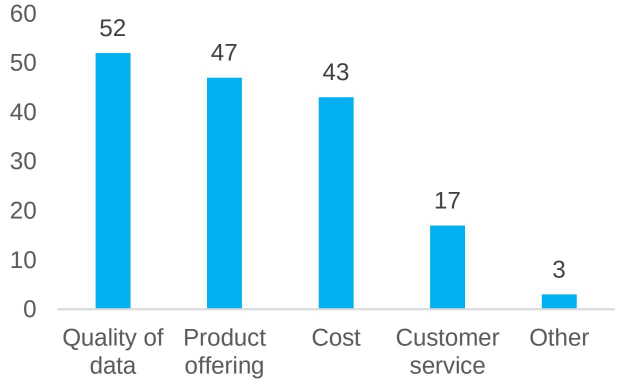
Figure 4. No regular frequency for the selection of ESG information providers



The survey also sought to understand the approach investors take to selecting such providers. Most investors do not regularly review their selection of ESG information providers, as almost 70% update their list on an ad-hoc basis, rather than on an regular basis, e.g. annually or every two years.

Question: How frequently do you update your list of ESG information providers?

Figure 5. Data quality, product and cost are the main drivers for changing providers



As to the criteria applied by investors when selecting providers, factors such as quality of data, product offering and cost are the three main drivers for changing providers.

Question: For which reason(s) do you update your choice of ESG information providers?

3. SATISFACTION WITH PRODUCT COVERAGE AND DATA COLLECTION

The survey contained questions to gauge the extent to which fixed income investors are satisfied with the products and/or services they subscribe to and why. As Figure 6 shows, at the issuer or portfolio level, most respondents stated they are satisfied with the coverage for investment grade (IG) corporate issuers, financials and developed markets, but have identified major gaps for all other types of issuers. These include high yield (HY) and emerging market corporates, leveraged loans, private debt issuers, US municipal bonds and structured products. This bias is not surprising, given that many IG corporates have equity listings.

Beyond investment universe coverage, investors flagged methodological issues as to why they were not satisfied with the information they received. Firstly, they see ESG evaluations as backward-looking – which means they may be late in capturing positive or negative changes. Moreover, respondents think there could be a more direct correlation between ESG risk and credit risk, especially given credit risk may vary over different time horizons, as bonds are issued with different maturities. These comments are not surprising either, given the providers have evolved from servicing equity investor clients, where the nature and dynamics of the equity asset class differs to that of the fixed income market.

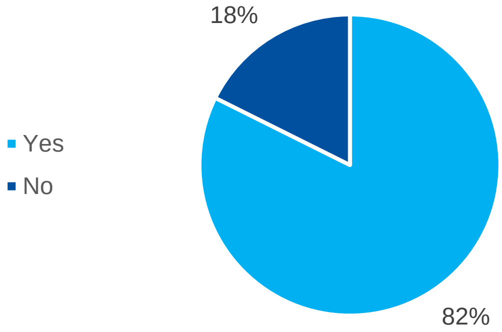
Figure 6. Good coverage for IG corporate issuers; major gaps for all other types of issuers and products

Question: How satisfied are you with the coverage: a) at the issuer level and b) at the portfolio level?

Note: the words in dark blue and a bigger font are the areas where investors thought coverage by ESG information providers was good.

4. DATA QUALITY AND METHODOLOGY TRANSPARENCY

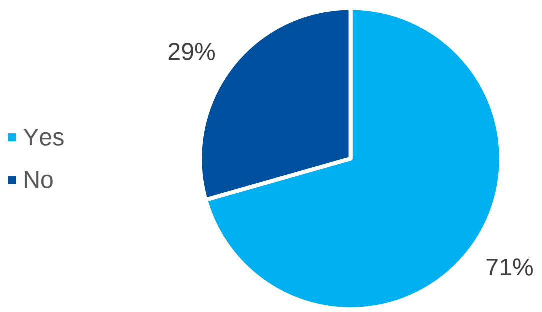
Figure 7. Investors claim to understand ESG information providers' methodologies…



Our questions also sought to assess the extent to which investors understand the underlying nature and basis of the ESG information, either in terms of the underlying data set, and/or the methodology used to arrive at the insight/opinion.

Question: Do you understand the methodologies developed by ESG information providers for FI assets?

Figure 8. … and state that they are regularly informed of any changes



As Figures 7 and 8 show, most respondents claim to understand the methodologies developed by ESG information providers for fixed income assets and to be regularly informed of any changes. However, interestingly, many investors observe a lack of transparency in methodology changes; some observed that communication tends to be commercial in nature, rather than clear and informative.

Question: Are you regularly informed of methodology changes, if any?

5. METHODOLOGY SUITABILITY FOR FIXED INCOME ASSETS

In recent years, the market has been trying to replicate ESG factor integration strategies from the equities space in fixed income. Similarly, ESG information providers developed their methodologies for equities first, before trying to apply them to fixed income. As the ESG appetite from fixed income investors has increased, we asked a set of questions to gauge whether these data-collection methodologies are suitable for this market segment.

Half of the respondents think that providers' evaluation methodologies are equally relevant to equity and fixed income investors – but some observed that understanding a provider's methodology should not be the end goal, rather it should be the starting point. Furthermore, it is the investor's responsibility to interpret this information and integrate it in investment decisions. One respondent noted that closer links between evaluation methodologies and the Sustainable Development Goals and green bonds would be beneficial.

The other half view ESG information providers' methodologies as mainly relevant to equity investors, particularly because these methodologies do not consider the different holding periods that fixed income investors have. Some respondents identify this bias at the outset and make corrections and adjustments accordingly. These comments are aligned with those revealed for the question featured in Figure 6.

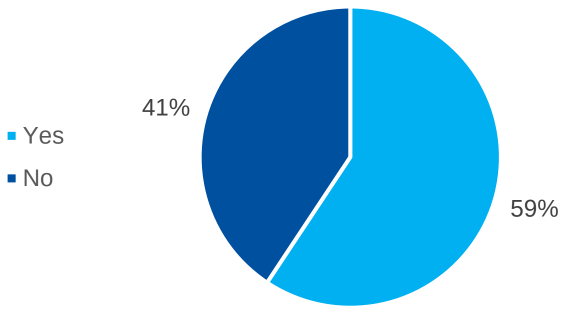
6. THE DIFFERENCE BETWEEN ESG INTEGRATION IN CREDIT RATINGS AND ESG EVALUATIONS

One of the key misconceptions that the work of the initiative has been trying to dispel is the confusion between incorporating ESG factors in credit ratings and ESG evaluations.

When asked to share their understanding on the difference between the two, most respondents refer to the integration of ESG factors in credit ratings as a risk-based approach, if the factors are material to creditworthiness. In contrast, they view ESG scores and providers' methodologies as broader and more holistic, and not necessarily material to credit risk.

The issue of time horizon is also mentioned – respondents think that credit ratings are more focused on the short term, whereas ESG evaluations take into account factors that can play out over longer time horizons. Investors are divided on the depth of analysis provided by ESG information providers compared to CRAs: some think that such providers offer a comparatively deeper and more comprehensive assessment of issuers, while others find them too general and superficial.

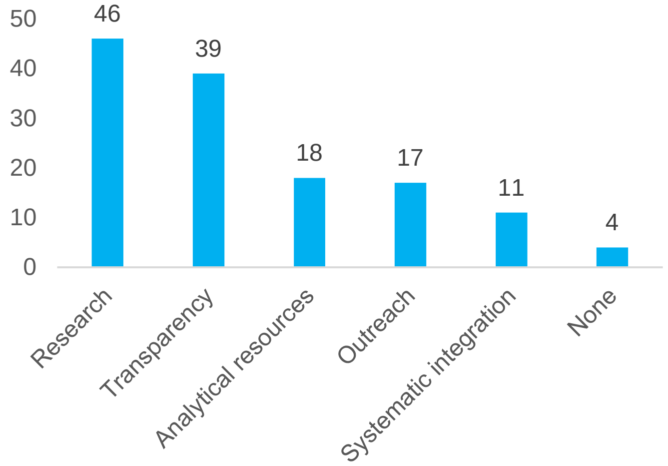
Figure 9. Fixed income mandates limited by credit ratings



More than half of responding investors stated that they manage strategies/mandates which are limited by credit ratings. This implies that the way ESG factors contribute to forming credit rating opinions, when they are material to credit, is important. Indeed, the difference between IG and HY has important implications for the investable universe.

Question: Is your investment mandate limited by credit ratings?

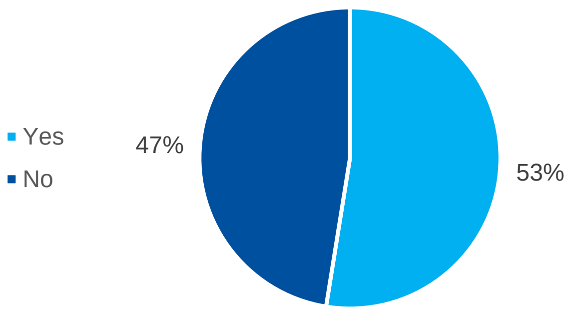
Figure 10. CRAs make most progress considering ESG factors in research and transparency



Since the launch of the PRI's ESG in Credit Risk and Ratings initiative in 2016, respondents observe that research and transparency are the areas where CRAs have improved the most, followed by progress in analytical resources and outreach. Some improvement is also noted in the systematic integration of ESG factors in CRAs' analysis and rating opinions, but the survey results indicate that more work is

Question: In which area(s) do you think CRAs have made most progress in considering ESG factors in their analysis and in rating opinions since the launch of the PRI Initiative?

Figure 11. Improved engagement between investors and CRAs



In terms of how investors interact with CRAs, half of the respondents stated that they engage with CRAs on a one-to-one basis, or as part of events they organise.

Question: Have you engaged with CRAs on ESG topics?

NEXT STEPS

The ESG evaluation landscape has developed significantly in the last few years. CRAs have made progress in transparency and in making ESG factors more explicit in their credit risk analysis. At the same time, ESG information providers have proliferated, and now produce more data and analysis, albeit their methodologies vary and are not always clear. The sector is dynamic and evolving, as demonstrated by increasing M&A activity, with some CRAs buying ESG information providers and vice versa. To clarify these ongoing developments and help fixed income investors to best use available tools and analysis, the PRI will continue to engage with CRAs. Furthermore, the survey results will inform future discussions with ESG information providers, with whom the PRI and credit analysts will begin to engage directly as part of the initiative.

Based on the survey results, the initial discussions with ESG information providers will focus on the following areas:

- Investment universe coverage of products and services;
- Appropriateness of data and methodologies for credit risk analysis;
- Differentiation between credit risks over different time horizons; and
- Transparency of methodologies and their scope and limitations.