PRI Principles for Responsible Investment

ESG IN CREDIT RISK AND RATINGS: BRINGING ANALYSTS AND ISSUERS TOGETHER

Swiss workshop

THE FINANCE HUB

GORDON AND BETTY MOORE FOUNDATION

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NOTES FROM THE SWISS WORKSHOP

The PRI's ESG in credit risk and ratings initiative is, for the first time, bringing voices from the corporate side into the conversation on how to better integrate environmental, social and governance (ESG) factors into credit risk analysis. This article summarises the key points from a Swiss workshop in the series 'Bringing credit analysts and issuers together', held with buy-side and sell-side credit analysts, representatives of credit rating agencies (CRAs), corporate finance and investor relations teams. This new string of workshops follows a series of 21 PRI-organised forums held between September 2017 and September 2019, aiming to nurture an investor-CRA dialogue and promote a transparent and systematic consideration of ESG factors in credit risk assessment.[1]

At the Swiss workshop, which was held on 10 December 2020, there were four discussion groups, with four companies participating across three sectors (chemicals, financials and food). Attendees included 17 investor or investment bank representatives from 13 organisations, as well as representatives from seven CRAs, the Association of Corporate Treasurers, the Centre for Climate Finance and Investment at the Imperial College Business School, and the World Business Council for Sustainable Development (see Appendix for a full list of participating organisations). The discussion was held under the Chatham House Rule. It was structured around guidelines that were circulated to participants prior to the event and tailored by sector.[2]

After hosting workshops exploring whether having an investment grade (IG) or high-yield (HY) credit rating mattered when it comes to ESG consideration, this workshop focused again on corporate bond issuers of mixed credit quality and from different sectors. Switzerland is known for good management of its natural resources, and is comparatively more advanced than other countries in the implementation of the United Nations sustainable development goals (SDGs). It also hosts a variety of companies for which the sustainability agenda is becoming increasingly important, including the food industry; the chemicals and pharmaceuticals industry; several industrial manufacturers and high tech-companies; and the financial sector.

Several observations in this workshop echoed those highlighted in previous workshops. In the remainder of this article, we only highlight new or sector specific themes, whilst remaining focused on credit-relevant ESG issues (such as the ESG factors that can impact a company's cashflow, and over what time horizon; the cost of transiting to more a sustainable business model, and the cost of not doing so; how to measure and compare ESG metrics for peer assessments; and so on).

[1] The workshops series follows a string of 21 roundtables organised for institutional investors' credit analysts and CRA representatives between 2017 and 2019. The discussions are documented in the trilogy, Shifting perceptions: ESG, credit risk and ratings.
[2] The PRI initially published these guidelines after the Paris workshop, the first of the series. They will be refined as the workshops continue.

1. EVOLVING GOVERNANCE ASSESSMENT

Good governance continued to be hailed as a fundamental prerequisite for sustainable developments. Echoing previous discussions, participants stressed that it remains the most credit-relevant of the ESG categories and a key feature of traditional risk assessment. It is also important to assess the oversight of environmental and social issues, highlighting the interdependencies of the three.

However, in addition to typical metrics (such as the board composition, the independence of its members, the frequency of its meetings and the track record of a company strategy), analysts are now considering some new key performance indicators (KPIs). These include board diversity; company accountability for sustainability strategies (including clear management functions and responsibilities, checks and controls); transparency (for instance on procurements); and corporate culture.

One issuer representative noted that whilst the scrutiny on gender diversity had clearly increased in the past few years, questions about the board's ethnic and racial diversity had started emerging after the revival of the Black Lives Matter movement in 2020. As a result, the company had started thinking about how to better reflect its global footprint at the board level. Another company representative added that they had recently recruited staff to focus on sustainability and ESG, adding to evidence from other workshops that new dedicated roles are being created.

"Enhancing board diversity has no cost implications but it requires more imaginative hiring solutions. Career progression may also take years of mentoring and investment in human capital" — Corporate borrower

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It may be some time before firms link executive pay to ESG targets, but this was mooted as a possible solution to make the board and senior management more accountable for sustainable developments. However, the debate is still open on which ESG targets would be appropriate, as some may be more suitable than others (depending on time horizons).

2. DATA AND COMMUNICATION STILL IN FOCUS

Echoing previous workshop discussions, participants noted the importance of data in assessing ESG risks, and the problems that can arise from a lack of clear disclosure requirements.

Participants also discussed the use of third-party data by investors and CRAs. While they agreed this can be a useful tool, they also noted it should not replace analysis by internal credit analysts. One investor observed, however, that reliance on third-party vendors for technical assessments is likely to increase when assessing environmental risks, given neither investors nor issuers have expertise in this area. Another added that investors would struggle to conduct stress tests on holdings internally, unless they had a dedicated team to do so.

It was agreed that setting an ESG strategy was an iterative process, and that until an external ESG data standard is created, issuers will have to define their strategies and then look to substantiate or adjust them using available data. To this extent, communication with analysts is crucial to make future plans clearer and enable analysts to make a forward-looking, rather than a static, analysis.

> “The key is to have a discussion with company management and engage with materiality frameworks, even though we may not always arrive at the same judgment on ESG consideration” — Investor

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It was suggested that companies start disclosing sustainability targets via their websites, like financial information. Furthermore, participants agreed that issuers hosting specific conferences or webinars targeting bondholders, like some companies already do, would be useful. Unlike in the case of equity investors, a register of bondholders does not exist. However, should these events become regular practice, they could become a feature of credit risk assessment over time.

3. LITIGATION

Several participants focused on the potential credit risks posed by litigation, although there was divergence in whether they considered it an environmental, social or governance risk. Specifically, in the chemicals sector, it was noted that the potential for regulation to forbid the production, sale or use of certain products or chemicals was harmful to the credit risk of companies as it could trigger future litigation, directed at them or within their supply chains.

One CRA representative pointed out that the materiality of litigation depended on the jurisdiction involved, as well as whether the litigation was public and reported in a company’s financial results.

Speakers observed that the financial and reputational risks posed by litigation were difficult to assess and price due to the fact that they often relate to historic events or controversies, and may not represent an issuer’s current management or business approach. Nevertheless, the fines related to such litigation can be financially material, and can be considered when looking at how a company mitigates losses. For the same reason, analysts may find it difficult to determine the true extent to which an issuer's management or business strategy has changed, if litigation related to past wrongdoing is ongoing.

"Consumer preferences have changed a lot over the past few years and so has the scrutiny on companies' supply chains and sourcing, boosting the risks of litigation" — CRA

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Litigation can be a material financial risk. However, it can also be a legacy of the past that weighs negatively on ESG scores, and does not reflect current management practices. Engagement can help credit analysts establish to what extent the underlying causes have been addressed, and what remedial action has been taken, beyond the payment of any fines.

4. TARGETS AND TIME HORIZONS

Participants highlighted that the long-term nature of many ESG issues, particularly environmental risks, makes it difficult to set appropriate targets – or to make lending conditional on meeting ESG criteria.

Still, especially on environmental issues, some participating companies noted that they had begun to set targets for carbon emissions (including, in one case, for Scope 3), waste and water. Two corporate representatives noted they had started reporting information according to the recommendations of the Task Force for Climate-related Financial Disclosures, and stress-testing the resilience of their business against the transition to a low-carbon economy. But one representative added that certain calculations are limited in projecting future actions and their results.

Participants noted that while the use of covenants has been rare, because quantitative easing has made funding relatively cheap, they could play a greater role in the future – encouraging companies to consider ESG targets and key performance indicators (KPIs). There was broad agreement that, at least for now, this type of conditionality has little impact on the cost of capital, but it does carry potential reputational benefits. One investor argued that there could be a risk of greenwashing if financing was conditional on meeting short or medium-term targets that are not credible.

CRAs are also starting to address the gap between long-term ESG issues and shorter-term financial metrics, with one participant indicating that they assess and differentiate companies based on the vulnerability risks they could be exposed to between 2025 and 2050. Another described combining two tiers of analysis: one focusing on the megatrends (such as ecological transition, demographic shifts) that will *potentially* impact issuers' credit quality and another looking at shorter-term forecasts which tend to inform credit rating opinions. Finally, one CRA started calculating ESG scores along with credit ratings to capture this long-term dimension.

"We are not sure whether the transition to a low carbon economy will be slow or rapid…the key is to have a discussion with the company's management to understand its strategy and planning" — Investor

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A company's willingness to tie its cost of capital to ESG parameters may add credibility to its sustainability approach. It was noted that issuers in the finance sector are beginning to use ESG targets or more conditions, such as reducing carbon emissions, to inform their own lending activities. Tracking companies' compliance and performance against these is difficult, however.

5. SECTOR-SPECIFIC CONSIDERATIONS

CHEMICALS	FINANCIALS
■ Sourcing of raw materials ■ Innovation ■ Product safety ■ Waste/water/carbon emission management ■ Supply chain risks ■ Responsible procurement	■ Governance factor is predominant ■ Environmental and social factors are more difficult to assess ■ Calculation of financed emissions is challenging; could be backward-looking ■ Litigation risks are material ■ Increasing scrutiny of board representation and diversity ■ More regulatory scrutiny (potential fines) ■ Cyber-security risks
FOOD ■ Environmental, social and governance factors are relevant and interrelated ■ Health and wellness are in focus ■ Consumer preferences and demographic trends ■ Innovation (e.g. plant-based products and reducing plastic packaging) weighed against cost/benefit analysis ■ Sourcing of raw materials ■ Certifications becoming an industry standard (e.g. B-Corp, RSPO) ■ Waste reduction	

APPENDIX

Table 1: Participating organisations

Sector	Companies
Chemicals	Givaudan, Syngenta
Financials	UBS
Food	Orior
Investment institutions	
Allianz Global Investors	Öhman
AXA	Partners Group
BNP Paribas Asset Management	SCOR SE
Colchester Global Investors	Swiss Life Holding
HSBC Global Asset Management UK	Swiss Life Asset Management
Invesco	UBS Asset Management
Morgan Stanley Investment Management	
CRAs	
fedafin	Moody's Investors Service
Fitch Ratings	Rating-Agentur Expert RA
Kroll Bond Rating Agency	Scope Ratings
Microfinanza Ratings	
Other industry associations	
Association of Corporate Treasurers	Centre for Climate Finance and Investment, Imperial College Business School
Word Business Council for Sustainable Development	

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