Principles for Responsible Investment

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

MINING SECTOR WORKSHOP

GORDON AND BETTY MOORE FOUNDATION

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United Nations Global Compact

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NOTES FROM THE 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 workshop held with issuers from the mining sector, bringing together buy-side credit analysts and representatives of credit rating agencies (CRAs), corporate finance and investor relations teams. This workshop is the seventh of the series Bringing credit analysts and issuers together, as part of the ESG in credit risk and ratings initiative, which promotes a transparent and systematic consideration of ESG factors in credit risk assessment.[1]

At the mining workshop, which was held on 11 February 2021, there were two discussion groups, with four participating companies (see Figure 1 below). Attendees also included 13 analysts from asset managers and investment banks, as well as representatives from three CRAs, the Centre for Climate Finance and Investment at the Imperial College Business School and the Global Compact Network USA (see Appendix for the 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 to the sector.[2]

Figure 1: Participating mining companies

Companies	
Anglo American	Newmont Corporation
BHP	Rio Tinto

After six workshops exploring credit-relevant ESG factors for issuers of mixed credit quality (investment grade and high yield) and geographical exposure, this workshop is the first one focusing specifically on one sector, the mining industry.

Mining, along with burning fossil fuels, is considered a "dirty industry" facing multiple ESG risks, including concerns around carbon emissions, water use, health and safety, and community relations. However, because it has comparatively higher exposure to these risks, the mining sector has started to focus on some of them earlier than other sectors. In doing so, it is undergoing a significant transformation.

During the workshop, we asked participants to address the following areas:

- Which ESG issues are the most financially material to the mining industry?
- How can ESG information be disseminated more effectively and linked to financial metrics?
- How can communication between fixed income investors, CRAs and companies be improved?
- What are the challenges and opportunities of the mining sector as it tries to balance the increasing demand for mineral raw materials with the need to transition towards more sustainable business models?

[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 are being refined as the workshop series continues.

Key discussion findings are grouped into four main areas, as follows:

1. Misalignment on materiality
2. Data reporting and dissemination
3. Communication
4. Facing uncertainty

1. MISALIGNMENT ON MATERIALITY

While all stakeholders – corporate issuers, investors and CRAs – agreed on the prevalence of numerous ESG factors in credit risk analysis for the industry, they did not seem to be aligned on which are the most financially material.

Companies identified tailing dam management, health and safety, human rights, climate and water among their key priorities. Many of these issues are not new from a risk perspective, but one company acknowledged that more in-depth conversations are taking place at the board level to view these issues from a sustainability and impact perspective.

Investors and CRAs expressed a range of views on materiality. For example, one investor flagged tailing dam management as a top ESG risk, as it is the easiest to quantify, and added community relations and health and safety to the list. Other investor representatives noted it was not a single ESG factor that mattered the most, but that management of transition risk, the reduction of greenhouse gas emissions and carbon footprint were at the core of their analysis. Climate targets were also specifically mentioned as being of high relevance. Finally, understanding how mining companies ensure their competitiveness over time and adapt to new regulation was highlighted as an additional key issue.

"A survey[3] on emerging ESG risks in the mining sector revealed that investors rank water security as their key issue, while companies consider emissions as their primary focus. This indicates a mismatch in priorities." – CRA

Corporate issuer representatives shared their approach to assessing material risks, which, in many instances, are identified for each mining site separately before being aggregated at the group level. Some corporates determine materiality annually through an internal process based on risk management, regulatory exposure and external input (including from civil society, customers and investors). This is a quantitative bottom-up approach, strengthened by top-down discussions with investors, customers and civil society. The materiality assessment does not vary significantly from year to year, barring outlier events like the pandemic.

One CRA observed that, whilst the effect of disruptions to operations may be easier and quicker to identify from a credit risk perspective, the impact of other factors, especially social issues, on credit risk assessment can be more difficult to quantify and may take longer to unfold.

[3] Survey conducted by a CRA in 2020 for investors and mining companies to assess key ESG risks for the sector.

“Ultimately the relevance of material [environmental and social] factors goes back to the governance of the company.” – Investor

Overall companies seemed to enjoy engaging with investment firms. Given that these companies have a comparatively high credit quality, corporates have less opportunity for investor engagement with bondholders than shareholders.

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More opportunities for company engagement with bondholders and site visits could help promote better alignment of understanding of financially material ESG issues, which can vary by mined material, the region of extraction and sometimes the individual plant level.

2. DATA REPORTING AND DISSEMINATION

Investor and CRA participants highlighted that data reporting is an important tool to gather ESG information, measure relative performance of mining companies across peers and identify where key risks and opportunities for improvement lie.

Compared to other sectors, it emerged that mining companies are more advanced on data reporting, as they already comply with several corporate frameworks (such as CDP, GRI, SASB, TCFD, UN Global Compact). Furthermore, some of the participating companies are members of the Initiative for Responsible Mining Assurance, which offers independent third-party verification and certification of mined materials against standards that were launched in 2018. The same year, the International Council on Mining and Metals (ICMM), a trade industry body that all attendee companies are part of, enhanced its principles for sustainable development. These principles, originally launched in 2003, were updated to strengthen performance expectations in support of progress towards the global targets of the UN Sustainable Development Goals and the Paris Agreement on climate change.

Companies embrace reporting for various reasons, including regulatory pressures, investor demand for more transparency and requests by ESG information providers. Additional drivers are a desire to strengthen their reputation and to maintain their social license to operate. The proliferation of various frameworks and questionnaires is a source of frustration, given the inconsistencies in format and content across the documents and the investment of time and resources required.

While acknowledging and welcoming these growing reporting efforts, investors highlighted that their needs for information were yet to be fully met. They pointed to the lack of data comparability between issuers, which makes it difficult to take informed decisions. As there are no industry standards yet, the data they use is very much shaped by the way in which companies report. While agreeing with the investors, a CRA representative also stressed that the merits of comparability may be limited as no two companies are identical – each corporate issuer needs to be assessed based on its own specific risks and opportunities.

In addition to data comparability, the granularity of disclosure was also discussed. Corporates generally capture group-level data in annual reports, while information relating to individual mining sites would be very helpful in understanding the company profile and informing investment decisions. An investor observed that more frequent updates from issuers would also be well received, as information can quickly become outdated

and wrongly used as a basis for investment decisions. The role of CRAs is crucial here, as they might have more frequent access to information through regular discussions with company management. An issuer representative responded that it was also important to keep in mind that producing standardised data more frequently was resource intensive and would take time to deliver.

"Companies could be affected by the issue of outdated data, if they are excluded from the investment universe based on information from their annual report that might no longer be accurate." – Investor

Finally, one investor noted that improved reporting and transparency could reduce the amount of time spent on fact finding or trying to ascertain whether claims regarding potential controversies are genuine.

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One company suggested leveraging the influence of trade bodies such as the ICMM to encourage greater standardisation of reporting standards, given that the largest mining companies are members (and all report according to GRI standards). Member expectations have already evolved from an original informal standard to a more prescriptive one. The ICMM could be influential in promoting better data reporting and dissemination. At the same time, companies would find it useful if investors communicated with a unified view which benchmarks and metrics are material to them.

3. COMMUNICATION

One of the challenges facing mining companies is identifying how to effectively communicate their sustainability strategy and performance to stakeholders beyond investors and CRAs, such as customers, local communities, NGOs and governments. As stated above, for this communication to be more valuable for credit analysts, reporting needs to be adjusted from a global corporate level to a more granular, mining site level. An investor noted that social issues were less quantifiable than E or G considerations, which often resulted in enhanced engagement to mitigate this problem. For investors and CRAs, the challenge is focusing on reliable and comparable social metrics to better understand the challenges companies are facing and how they tackle them. In the meantime, the ability to visit mining sites is greatly valued by investors, as it is a significant source of information that supplements the existing data.

Frequent accidents occurring in the sector have increased the pressure on companies to improve the management and transparency of their environmental and social impacts. An investor raised that they would like to see enhanced prevention measures from the companies, in addition to them reacting in the aftermath of an incident. Companies said they have increased preventative measures through lessons gained from experience. Both practical and reliable data is needed to better communicate the value of corporate activities.

It was discussed how difficult it is for investors to grasp the social risks and opportunities faced by each company, and how this will impact the critical social license to operate.

"At the moment, only deep engagement conversations with firms can help us get a sense of how social risks are managed." – Investor

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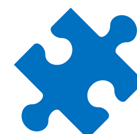
Investors envisage third party assurance as another solution to the multiple problems posed by the lack of standardisation. An external audit of company metrics against their targets could produce comparability of data – year on year and across mining sites – helping to highlight issuers that consistently underperform and fail to mitigate key ESG risks.

4. FACING UNCERTAINTY



Most issuers attending the workshop will have to refinance their debt in the short to medium term, as a significant amount of their bonds will expire in the next five years. Their access to capital and cost of refinancing might drastically change over this time span and could be affected by how well mining companies are managing ESG risks and opportunities. An added uncertainty is the evolving materiality of ESG issues. In this increasingly complex environment, there is no guarantee that the key ESG issues of today will remain the same in the future. Companies expect the physical risks arising from climate change to increase; the pace of regulatory change is also a source of concern.

A CRA representative raised a major question, envisaging the survival of the industry as a whole: how can mining companies extract commodities in a more environmentally friendly way? One of the corporates reminded participants that metals are needed in the transition to a low-carbon economy. As opposed to fossil fuels, which have viable alternatives (such as renewable energies), steel and copper do not have substitutes. For the investment community, it is important to focus on issues that are likely to increasingly materialise in the future, such as biodiversity and water. As stated by an investor and a CRA representative, companies which are embarking on the circularity journey now might be better suited to face tomorrow's challenges.

Lastly, participants discussed the usefulness and attractiveness of new labelled financing instruments, such as green and social bonds, and sustainability-linked bonds (SLBs). Whilst acknowledging that labelled bonds can be an interesting tool to connect financing activities to the broader sustainability strategy, companies agreed that these bonds are not essential to deliver on this strategy. They can solidify the company's commitments, but, in the end, strategy is the sole driver of activities.

"We use scenario analysis for a variety of purposes, including when we look at energy supply for our operation, so in the climate space this type of analysis is very important." – Corporate borrower

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For investors, the flexibility of mining companies in adjusting their business model to the transition to a low carbon economy is key. They seek to ensure that their portfolios are aligned with the long-term issues they identify. They assess the resilience and agility of companies to determine how they will respond to potential regulatory changes and multiple risks. Scenario analysis can also be used to assess risks and allocate capital in the future.

APPENDIX

Figure 2: Other participating organisations

Investment institutions	
APG Asset Management	Federated Hermes International
Bain Capital	Janus Henderson Investors
Barclays	Morgan Stanley Investment Management
Brandywine Global Investment Management	Neuberger Berman
Christian Brother Investment Services	Ninety One
CNP Assurances	Swiss Life Asset Management
DDJ Capital	
CRAs	
Fitch Ratings	Moody's Investors Service
S&P Global Ratings	
Other industry associations	
Centre for Climate Finance and Investment, Imperial College Business School	Global Compact Network USA

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