THE PRINCIPLES FOR RESPONSIBLE INVESTMENT PODCAST TRANSCRIPT

ESG IN CREDIT RISK AND RATINGS

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Sixtine Dubost

Welcome to the PRI podcast and the latest episode in our ESG in credit risk rating series. My name Sixtine Dubost, I am a Senior associate in the investment practices team at PRI and I am delighted to be your host today. Responsible investment practices are evolving across asset classes and fixed income investors are becoming more demanding as they are building internal ESG assessment frameworks. From large global institutions to specialist managers, credit investors have grown their expectations and their demand for data and insights targeted to the UD characteristics of their asset class. The ones with enough resources have started developing in-house metrics and want to have access to raw ESG data from information providers and for the investors that continue relying on the

ESG scores or evaluations computed by these external providers, improved transparency is crucial. So how useful are data and service offerings from ESG information providers for fixed income investors? How are the current products evolving and where do gaps remain? To answer all these questions, I'm very happy to be joined today by Erika Wranegard, fixed income portfolio manager at Lombard Odier asset management and Mike Ferguson, senior director and analytical manager, Sustainable Finance Americas at S&P Global Ratings.

Sixtine Dubost

Hello and welcome to you both.

Erika Wranegard

Thanks for having us.

Erika Wranegard

Hi Sixtine. Thanks for having us.

Sixtine Dubost

So, let's start with you, Mike first, S&P global provides a wide range of products and services for different purposes. There is the credit focused ESG evaluations on one side, but also broader non-credit ESA research and scores on the other. So, do fixed income investors need all of these products?

Michael Ferguson

I'll leave it to the investors themselves to decide whether they actually need all this information. Maybe I can explain what the difference is between it and maybe what the applicability of some of these are. As you know, we are ratings agency, we'd be doing credit ratings for a long, long time. We've been capturing ESG in those credit ratings for well longer than ESG has actually been a term that's been used that certainly environmental risk has been present in credit quality for a long time. And our recent attempts at, capturing ESG in credit ratings are not as if we're capturing it for the first time. It's more that we are seeking to provide transparency into how it is that ESG impacts credit quality. We've recently put out ESG indicators for a variety of different sectors. And the goal with that is just to show the extent to which ESG factors are already influencing credit ratings.

Michael Ferguson

Periodically, we'll try to show how it is that ESG factors are driving changes in credit quality. So we saw that during the pandemic a lot, for instance, there were a lot of social reasons why credit ratings fell and then in some cases rebounded. That's on the credit side where we're trying to provide a bit more transparency and just make more explicit the connection between ESG on the one hand and credit quality. Now, in addition to that, as you say, we’ve done a lot of other things that are around ESG, which happen within our ratings division. And nonetheless, some of the products that we have are not themselves ratings products. We have ESG evaluations, which look at a suite of different ESG factors with the intent of assessing the sustainability of a company longer term, going way beyond just kind of financial wellbeing and we also have second party opinions.

Michael Ferguson

We're assessing whether a financing or a framework meets a certain set of principles, the green bond principles, let's say. Now the difference there is that when we look at credit ratings, the fundamental question is whether or not a company or an entity can repay its debt. And if ESG impacts that, then we comment on that. The other products I talked about are, you know, they refer to how it is other stakeholders are impacted, which I think is a question that's being asked a lot more by investors now, right? I think investors historically kind of had this singular focus debt investors on how it is that that debt would be repaid, and we're interested in whether or not ESG could impact that. But I do think that with fixed income investors, now sometimes their stakeholders are kind of asking them to go a little bit beyond that.

Michael Ferguson

And I think some of these other products that we have kind of speak to how it is other stakeholders are impacted, whether that's communities or customers or employees, or what have you more than just financial stakeholders. To whether or not investors need all that, I just think it's a different data point that kind of provides a different perspective. Our hope is that with the industry knowledge that we bring to the table, based on our credit ratings background, that we can apply the same rigor that we do on the rating side, just using a different perspective.

Sixtine Dubost

Thanks a lot for clarifying the difference between all these products, because for investors and for market participants more broadly, it's not easy to navigate this jungle of new products and services that are being created. And especially because fixed income investors have been using more and more providers, data and services to either better inform their in-house research work simply to use scores and evaluations directly. So, Erika turning to you now as a portfolio manager with the sustainability focus, what is your approach at Lombard Odier asset management.

Erika Wranegard

At Lombard Odier investment management, we believe that we're under verge of profound change within our economic models. We're moving from a linear economy into a circle or economy. So, we named it that we are moving from a "wild" economy, which is wasteful idle loop sided and dirty into the "click" economy the circular lean inclusive and clean. And this shift from the linear economy into a circular and renewable net zero economy will pose major investment opportunities for investors. It will also be a radical economic shift that we are undergoing. To help our clients navigate this shift from a linear into circular economy we have developed in-house tools into assess the sustainability risk of this transition. These sustainability methodologies are drawing on raw ESG data provided just by third party investment sustainability providers. There's particularly two ones, which I'd like to highlight, our internal ESG or naturality score assessing the ESG. So, environment, social government risk throughout the value chain and more interestingly, which I think is more forward-looking science based is Lombard Odier, implied temperature rise tool. Which is assessing companies, decarbonization strategies, and whether the decarbonization strategy is in line or not with the climate objectives that we have to reach in order to reach our global climate goals. So, across all internal sustainability tools and methodologies, we use the raw ESG data into calibrating, our own ESG scores and methodologies.

Sixtine Dubost

I love your wild and click acronyms. They're very easy to remember as opposed to some of the ones that we can hear in the market. So, you've been part of our engagement through the ESG and create risk and ratings initiative at PRI. We have found through several runs of calls with ESG information providers that take that coverage and quality still challenging. What are your biggest asks to third party providers as an investor?

Erika Wranegard

We have come a long way since we started those calls. I think it was now a few years back, but there are four things which I like to highlight, which was really representative from those calls and how the sustainability data for fixed income investors differ from the equity side. Starting off with the coverage for fixed income instruments. So fixed income investors, we invest across different types of issuers. So we have corporate issuers, sovereign issuers, and then there's also structured products, to name a few of the different products. And we see this coverage varies depending on what type of products we're looking for. First ask is to improve the coverage and focus the coverage or fixed income instruments rather than basing it on the equity issuer. Secondly, it's the data quality, as you mentioned in your introduction, Sixtine, that investors require more transparency on the data sources that is used to understand what the data points are, which is trying to capture. For us investors really understand what's the risk that this data point is capturing in order for us to better assess the risk within the investments that we undertake.

Erika Wranegard

Thirdly also relates to transparency, but that's relating to the methodology. So there's different methodologies. And we investors would like to see much more clearly and more transparent methodologies. And that particularly also when it comes to updating on the methodologies to understand how the methodologies change in order to understand what's the different in the risk that the new and the old methodology capture and how should we then change our investment approach to assess the risk, what isn't captured with this new methodology. Fourthly it's about the product offering, that it should be mapped to the fixed income issuers. I think that investors now, depending on if you have the in-house capabilities to develop your own tools, whereas investor that might be looking for tools already developed now, not only looking for ESD data for specific issuers, but looking for analytical capabilities to understand what's the impact on the portfolio level.

Sixtine Dubost

Mike hearing these asks from Erika from the investor side, can you share what has been the progress made by S&P over the past years, especially in terms of data coverage and quality, and methodological transparency.

Michael Ferguson

Sure, I'll start with the last part of that first becomes methodological transparency we're as I said, a ratings agency. And so, it's pretty critical for us to make sure that the process by which we produce credit ratings, or any other product is made really clear to the users. And with ratings, one of the things we've been trying to do this kind of show very directly, how these different ESG factors can influence credit quality. We have an existing corporate ratings methodology. And so, the goal is to show someone for instance, where greenhouse gas emissions comes into that methodology or where it is that governance fits into that methodology. And so, a lot of our efforts have been in adjust that it's kind of identifying where it is that different factors are influencing the credit ratings methodology that we already have. Another thing that we're trying to do when it comes to our non-ratings products, is that we produce what we call key sustainability factors, articles.

Michael Ferguson

The goal of these, is to make it pretty clear on a sector-by-sector basis, which factors are actually knowing the most material, which are the most relevant. You talked about the materiality maps earlier. And the goal of those is just to make pretty obvious for a given factor, let's say physical risk of climate change, how it is that that impacts stakeholders and how it impacts financial credit quality. Again, that's the transparency that we're trying to show here that changes over time too. I think sustainability is a rapidly evolving field and we obviously want to stay on top of that very closely scrutinizing the data sources that we use. On the E side we're a lot more advanced on that. We feel confident in our ability, in our analyst's ability to use things like greenhouse gas emissions in an effort to compare the exposure that the companies face.

Michael Ferguson

That is not uniform, yet as we run into some problems on data transparency that are not of our own making greenhouse gas emissions is a bit easier. But when we look at things like diversity metrics, for instance, they may be reported in different units or with different regularity from jurisdiction to jurisdiction and from company to company. We have come a long way on this, but it is incumbent on the companies that are producing this information to provide comparable data. That is the key thing that investors keep asking us about is whether or not is data. It is nice to look at, it's helpful, it's explanatory telling a narrative, but it's not always comparable. If you had an, a combination of this focus on materiality that we have as a ratings agency with more comparable data, you know, investors really be in a good position to both figure out what's important and then figure out which companies are doing it better than other ones are.

Sixtine Dubost

Given your interactions with fixed income investors. Do you think that they are asking the right questions to providers and why related to what you just said about comparable data materiality, et cetera?

Michael Ferguson

I think so. So, I think increasingly the fixed income investors that we speak to, and I wouldn't want to generalize of course, but I do think the ones that, that we talk to are becoming increasingly sophisticated in asking about materiality. That's kind of the conundrum when it comes to sustainability reporting, you know, you guys have reviewed sustainability reports, they're voluminous, they're long, they're colourful and they're not always relevant. And I think that fixed income investors are, have gone through those. And now they're starting to ask us, you know, I went through this hundred-page sustainability report, which data points in here are actually important, which ones should I care about? And then ultimately, how is that impacting the credit rating that I'm interested in for this company? So, I do think fixed income investors are getting better and they are also asking about data sources. I think that is the important thing they're frequently asking us. Who do you rely on? Are you relying on industry groups, provide data? Are you taking the company's word for it? Are you doing your own independent analysis? We get asked whether we're auditors or we're not. I think that there's curiosity among fixed income investors about what data sources are going be relevant for their analysis. And I think that they're kind of aligning around consensus on the E side, but maybe not so much on the S side just yet.

Sixtine Dubost

And now moving on another important topic, which is regulation and turning to you from the investor perspective, which role do you see the increased regulatory pressure playing in addressing these challenges and filling in the gaps you mentioned before?

Erika Wranegard

So, I think that what we can see is that the voluntary standards that we have seen, so they've been great for laying the foundations of sustainability reporting, but that also means that we see a wide variety when it comes to the quality of the data that is reported and how the different numbers are being calculated. So, regulation can obviously help when it comes to the consistency on the numbers and how the different metrics shall be calculated. And from us investors make it much easier to comparison than they like for like basis. So, I'm based in Europe. So, it's a EU taxonomy and ESSFDR, that's defining what screen and what's not green. And in one to two years' time, when we see that the issuers are reporting on that, that will be easy to compare, but I wouldn't say it does not take away the need for fixed income investors to engage further within sustainability analysis to assess the holistic risk characteristics of the issuers. So yes, it will help, but there will still be a strong need for us to assess sustainability data, incorporate that within our analysis.

Michael Ferguson

There's kind of an interesting analogy here between what we talk about with sustainability now, and then financial reporting. Erika's right, obviously better regulation will mean more harmonization and metrics, but that's already true. And it's been true for, you know, eighty or a hundred years on the financial side, but you should still ask questions about that. So, you can put the numbers into the appropriate context as fixed income analyst, whether it's a ratings agency, or it's someone who's in asset management, try to do forward looking analysis. And I think the big challenge of ESG data, as I see it is that when you look at it, you look at what's been reported. It is historical. It doesn't tell you a whole lot about where the company is going, which in a lot of ways, especially when you talk about energy transition or diversity, that's more important, is how the company is transforming. And so, I think that it's kind of incumbent on analysts, not just to have good information, but use that to ask good questions.

Sixtine Dubost

The issue of time horizons and giving longer term views is something that we've heard from both investors and credit rating agencies and information providers, as well as one of the main challenges. But regardless of the remaining problems that still need to be tackled, the ESG information provider's landscape is not static. It continues to evolve with credit rating agencies, acquiring providers and vice versa. Erika, what are your thoughts on the current consultation we're seeing in the market?

Erika Wranegard

I think to speak to as to what happened over the market for the last couple of years, that would come a very long wait with integrating sustainability in a very short period of time. And obviously the consolidation and buying the resources, incorporating them in house has helped building sustainability knowledge quickly, which we haven't been able to capture with the organic growth. We've seen the tremendous organic growth as well when building this, the knowledge and capabilities within sustainability. So, I think it's a natural evolution by recognizing the need for us to build the knowledge base. And then going forward on climate, we see that it's becoming more and more standardized, how Greenhouse gases should be calculated, analysts are becoming more and more comfortable into incorporating that into their analysis. But we still see we're lagging it when it comes to other environmental factors, such as biodiversity and other social factors, such as human rights. And there, I still see that there will be new entrance entering the market as to how we're going to capture that risk. And so, there be plenty of growth opportunities, and we're also going to see consolidation continue to grow in there.

Sixtine Dubost

Erika, we've heard you sharing what you're seeing in the future and Mike, in light of this, what are your thoughts as well? Where is S&P focusing new productive developments for fixed income markets and how is the market going to evolve?

Michael Ferguson

In terms of how the market's going to evolve I do think, Erika brings up a good point here that it's a question of like knowledge and savvy when it comes to ESG. I just think whether it's ratings agencies or it's fixed income investors, or it's the equity markets or whoever regulators, I think that a lot of these topics, you know, Erika mentioned biodiversity. These are things the market doesn't totally grasp right now. And I think that if we don't totally understand it, we can't ask for the right data and then we can't incorporate it in our analysis. And so, I think there's kind of a reckoning to come. It has come on greenhouse gas emissions, but I also think on other topics, it's kind of critical that financial market participants educate themselves. And I think that that'll help them ask good questions about what is material for the sectors that they're looking at and then how it is they make judgements about which companies are doing an effective job and which ones are lagging. That's at the heart of a lot of the analysis that we do are, are non-credit ESG analysis.

Michael Ferguson

A lot of what we are focusing on is, you know, looking at these factors and figuring out within a given sector, who's doing a good job and who's not doing so great because a lot of these things are not financially material right now, but could be over time. And at the heart of our analysis is a lot of rigor around how it is that we look at financial pathways and how it is something that's not material today becomes material over time, because I do think fixed income investors need to understand that how something goes from being just kind of this niche stakeholder issue today to being an existential financial issue at some point in the future. So, I won't depend on what those are because it varies from sector to sector. But I do think that, especially with better regulation, with more comprehensive regulation and more transparency, you know, investors are really going to hopefully have the ability to hold companies accountable for the judgments that they make around ESG topics. And with that, there comes financial consequences potentially we've already seen on the transition side, but that is probably just the beginning.

Sixtine Dubost

We have been hearing the same thing, managing to identify the issues that are not necessarily material at the moment, but will become so in the future is absolutely key. In doing so, keeping the engagement going between all the stakeholders in the market is very crucial as well.

Unfortunately, these thoughts on the future of the market bring us to the end of our conversation. I wish it could be longer. I would like to thank you, Erika and Mike, for this very insightful conversation. A reminder that this podcast series is part of a project called the ESG in credit ratings initiative, which Lombard Odier asset management and S&P global are supporting along with another 27 credit rating agencies and 108 investors. You can find all resources that we've produced so far on our webpage Unpri.org/credit/ratings, where there is also a statement of support that can still be signed by PRI signatories. Thanks a lot for listening, and don't forget to tune in for our next podcast. And until then, goodbye.