



## Integrating ESG in credit ratings still a challenge

By [Ishika Mookerjee](#) 12 Dec, 2018

It's been one year since US credit bureau Equifax revealed that a hack had exposed the data of over 145 million customers, including their social security numbers. Following the announcement on 7 September 2017, the share price dropped 13% overnight to 123.23.

Surprisingly, some investors were breathing a huge sigh of relief when the Equifax announcement was published.

'You could see that they had data security problems coming up. All the scores deteriorated prior to that incident when they suddenly released that their data had been hacked,' said Jan Poser, chief strategist and head of sustainability at Bank J Safra Sarasin.

'So we dropped it out of the universe, thankfully, before the big incident happened.'

Poser was referring to the sustainability scores of Equifax in the Swiss private bank's sustainability matrix, which conducts analysis on the equity and bond investments made by the bank on behalf of clients.

When it comes to credit risk, Poser also expected bond rating agencies – be it Moody's, S&P or Fitch -- to conduct their own analysis on environmental, social and governance (ESG) factors to supplement the bank's information.

'There is a very strong link between ESG and fixed income investments in particular, because as fixed income investors, you should actually avoid risks. The default risk of sustainable companies is much lower than that of plain vanilla companies,' Poser said.

## **Data woes**

In fact, meeting client demand for ESG incorporation is one of the biggest challenges facing credit rating agencies today, a UN Principles for Responsible Investment study has found.

One reason for that is that there is still a lack of understanding of the impact of ESG issues on yields and spreads and the quantifiable link between ESG issues and the default probability of companies.

Philipp Aeby, CEO of ESG research provider RepRisk, said that while major rating agencies have a treasure trove of historical data on defaults, there is a big gap in the corresponding data for the ESG issues faced by the defaulters.

'There is little evidence so far of this correlation, and the reason for that is that it is difficult to get the corresponding data,' Aeby said. 'So, basically, it's a bit of a shot in the dark [today].'

Looking to fill this gap in the future, RepRisk has created a framework to identify companies exposed to ESG risks, using reports from local non-government organisations, national media and international news outlets to feed its research.

Globally, ESG practitioners are trying to address the problem by creating consistent, international standards by mandating bodies like the Task Force on Climate-related Financial Disclosures.

However, the uptake of global standards has been low. The disclosed data on carbon footprints and emissions, for example, is often poor quality and sketchy, say Poser and Aeby.

To this end, Hong Kong's regulator launched a green finance strategic framework in September to improve listed companies' disclosure of environmental information, with an emphasis on climate-related risks and opportunities.

The situation is far worse for social issues, as companies will never self-report cases of child labour, human rights, corruption or bribery, Aeby pointed out.

That's when you really have to rely on the evidence on the ground and get reports from government agencies, local NGOs and domestic press, he said.

Doing on-site visits is extremely important when there are inconsistencies in raw data, Bank J Safra Sarasin's Poser said. It's also a great way to engage the companies and contribute to improving their ESG scores, he added.

### **Moody's models**

After finding the right data, the next challenge faced by agencies is building credit risk models that incorporate ESG issues when forecasting default probabilities, Aeby noted.

Some agencies have been working towards a solution. Last year, Moody's published a report explaining what it considers as material ESG issues in its credit ratings.

For example, for non-financial corporates, Moody's assesses how ESG issues influence the drivers of credit quality, such as demand for products, reputation or costs of production.

For sovereigns, it looks at how ESG-related considerations – for example, country competitiveness, control of corruption, rule of law or climate change – affect government creditworthiness.

Moody's has also developed analytical frameworks to assess the impact of an ESG issue on a sector, and the agency is incorporating material ESG issues into its scored factors in a given rating methodology.

In the report, Moody's said that sector-wide ESG exposure is also captured in its industry analysis to inform the rating positioning of an entire sector.

'This is one of the reasons why all investor-owned coal mining companies globally are currently rated below investment grade,' the report noted.

### **Focus your intentions**

With wealthy clients increasingly demanding ESG considerations in their investments, Poser believes the theme can be played in fixed income by reducing the duration of bonds, depending on the nature of the risk.

For example, if it is a long-term risk like carbon emissions or stranded assets, you can buy shorter-dated bonds, he said.

'If it's a product safety issue or risk management issues in the company, then you'd want to get out,' he said.

Aeby, meanwhile, said that ethically-minded investors should also focus on smaller companies, because those are the ones that don't have deep pockets in case of an ESG-related crisis.

He added that looking at the lending portfolios of corporate and investment banks can also give deeper insights into the ESG risk exposure of firms, as they incorporate this analysis when financing companies.

In Asia particularly, this can be used as a reference for large conglomerates that have a lot of credit lines, he said. 'It must play a role in high yield bonds,' Aeby concluded.