ESG GAINS GROUND IN CREDIT RISK ANALYSIS

By Carmen Nuzzo

No longer neglected by fixed income markets, institutional investors and credit rating agencies are increasingly paying heed to environmental, social and governance (ESG) issues, starting with credit risk analysis.

Once the exclusive focus of equity capital markets, environmental, social and governance (ESG) factor consideration is rapidly broadening to fixed income assets. Notably, it is catching the attention of institutional investors and credit rating agencies (CRAs) when they assess credit risk – one of the most important risks of investing in bonds, as it measures the probability that the money an investor lends to a bond issuer will not be repaid. However, lessons about how to integrate ESG factors in credit risk analysis are still being learned, and ESG consideration is far from systematic.

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There is a substantial opportunity to contribute to making the financial markets more sustainable, with nearly US \$97trn[1] of global bonds outstanding. But only recently – taking their cue from equities – have fixed income market participants started appreciating the importance of incorporating non-financial variables in the assessment of creditworthiness.

Admittedly, governance has traditionally featured in credit risk analysis, as it tends to be assessed as part of investors' due diligence process. However, corporate scandals which have triggered sizable financial losses in recent years and the devastating effects of the global financial crisis are stark reminders of why a lack of proper oversight, transparency and accountability can negatively affect fixed income market pricing, volatility and, ultimately, financial stability.

Beyond governance, the business case for integrating ESG factors is becoming increasingly compelling as the effects of climate change are more visible and investors are beginning to grasp how social factors – such as workforce diversity, labour conditions and employee development – can impact a company's financial performance as well as its reputation. Growing appreciation of these issues is helping market participants to manage downside risks.

Since many fixed income investors buy bonds for capital preservation, it is critical that – where material – these factors are systematically included in bond valuations. This need is particularly pressing for insurers and pension funds, which own large quantities of fixed income securities for asset-liability management and have a fiduciary duty to their policy holders and beneficiaries.

Beyond stewardship and risk management, sophisticated investors are learning how to model ESG factors to spot market mispricing and opportunities. Indeed, some are beginning to create internal proprietary ESG indicators to help with bond pricing. They are also demanding more clarity from CRAs to understand what is already factored in their rating opinions and avoid double counting.

More positively, fixed income investors and CRAs are allocating more resources to understanding ESG issues, including appointing dedicated analysts, publishing research and increasing budgets. This is one of the main findings of 'Shifting perceptions: ESG, credit risk and ratings – part 1: the state of play', a recent research report by the UN-supported Principles for Responsible Investment (PRI).

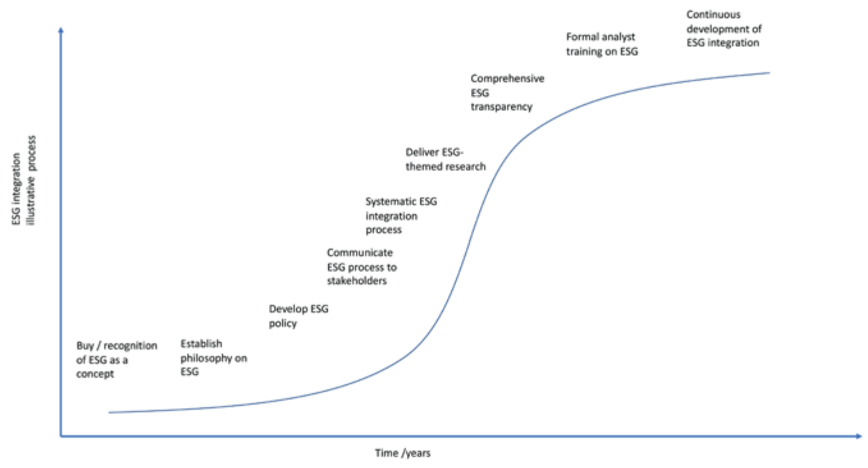
However, the report also found that ESG integration is not yet systematic, despite investors and CRAs having moved ahead of the initial recognition of ESG as a relevant investment concept. Evidence of refined methodologies to include environmental risks in rating opinions and improved competence in this space is increasing, and some of the largest CRAs are leading the pack. But we have yet to see real influence on rating changes and outlooks, and shifts in asset allocation (by sector or region). On the investor side, ESG integration can often be advisory in nature and the responsibility may fall on ESG analysts alone to raise red flags. Both sides need to better communicate their ESG integration processes.

Because of their unique role in fixed income, CRAs play a crucial part in promoting ESG integration in credit risk analysis. Even if credit opinions represent just one input in an investor's assessment of creditworthiness, they are closely monitored by market participants that may trade on potential upgrades or downgrades. Furthermore, credit ratings often define or limit investment mandates. They are used for a range of other market applications – such as the eligibility of collateral or credit enhancement in structured finance transactions – and by a variety of market players, including central banks.

It is also important to distinguish ESG consideration in credit ratings and what are now commonly known as ESG ratings. These scores or assessments measure how well security issuers perform on ESG factors relative to their peers. They can help investors make more informed decisions but do not capture the implications of ESG factors on issuers' balance sheets and hence their relative risk of default. In other words, they are complementary but distinct products from credit ratings. They are also compiled by unregulated third-party service providers.

Although investors and CRAs are intensifying their focus on ESG issues in credit risk analysis, 'Shifting perceptions: ESG, credit risk and ratings' identified several disconnects. These include the time horizon over which ESG factors are deemed material, and differences in the perspectives of risk assessment among investors and CRAs: investors tend to focus on the overall financial performance of an issuer, not just on its default probability, like CRAs.

Figure 1: Investors and CRAs are at different stages of ESG integration in credit risk analysis - Illustrative timeline



Source: PRI

Ultimately, a key issue to address is the institutional changes that must occur to make ESG integration more systematically embedded in credit risk analysis. How should credit analysts be incentivised and equipped with the right resources to broaden their analysis beyond traditional financial variables? What is the role of senior management in promoting the systematic and transparent integration of ESG factors in credit risk analysis? And should regulators also have a role? Finally, should investors and CRAs demand enhanced data disclosure by issuers?

It is encouraging to see that the dial is beginning to move in the right direction, but ESG consideration still seems to be widely viewed as a 'nice-to-have', in response to rising commercial pressure, rather than a 'must-have'.

More work lies ahead: the initiative that the PRI is leading follows the 2016 launch of the 'Statement on ESG in Credit Ratings'. So far, 129 investors (representing more than US $23trn of assets under management) and 14 CRAs – more than double the original number – have signed the statement, which remains open to new supporters. «

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- ESG consideration in fixed income assets is gaining traction - investors and credit rating agencies are beginning to question the impact of non-financial variables on bond credit risk.
- ESG factors are not completely new to credit practitioners - some already feature in credit analysis, but are not labelled as such.
- Their integration is becoming more structured and new risks are emerging: more work lies ahead to understand which ESG factors can impact bond issuers' balance sheets and when they become material.

This article was written by Carmen Nuzzo, Senior Consultant, Credit Ratings Initiative at the UN-supported Principles for Responsible Investment.