CREDIT PERSPECTIVE | 2021

Embedding ESG into Credit Risk Assessments

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Risk Better.

CreditSights

From forest fires to permafrost melt and populist politicians to social unrest, Environmental, Social and Governance (ESG) issues are dominating news cycles globally in 2020. The question from a credit perspective is not whether those factors need to be incorporated into the analysis of risk, but how to do so in a way that is as consistent as possible across sectors and time.

As the leader in independent, global credit research, CreditSights is beginning a process of including ESG issues, in as consistent a manner as possible in our overall analysis of credit risk. That will see CreditSights analysts integrate that approach to ESG into the way they cover issuers in North America, Europe and Asia Pacific, spanning both investment-grade and high-yield. **Our ESG framework serves as a bedrock for complete and holistic credit risk analysis going forward.**

Our ESG Credit Risk Core Beliefs

Our ESG methodology is based on the following core beliefs:

- **E, S and G issues are potential sources of material credit risk** (current or nascent and unrealized). If those factors are sufficient to affect the probability of default, the loss-given default or the performance of the bonds, then they should included when considering credit risk.
- **The priority claim and limited upside that bonds enjoy make downside risks more important.** That makes ESG fundamentally different from a fixed-income perspective, since oversight of those areas can put bondholders' interest at odds with those of equity stakeholders and management.
- **Truly material ESG factors affecting credit risk are not always the same as those that dominate the headlines.** Controversy does not always equate to materiality.
- **How factors within E, S, and G affect different companies in different sectors can vary enormously.** Therefore, a one-size-fits-all approach is not possible.

Interpreting E, S & G Factors

While ESG is frequently bandied around as a catch-all for ethical behavior, environmental awareness and community engagement, it is worth defining how we interpret those factors, using quantitative measures whenever possible:

Environmental

Companies that are chopping down rain forests, polluting the air and rivers, or prone to hazardous spills might be maximizing short-term profit, but they are guilty of relying on operating practices that create longer-term risks. Regulatory changes, consumer boycotts, imposed fines, and mandated investments in greener technology can all undermine credit metrics.

Social

We consider the company's relations with and treatment of stakeholders, including customers, employees, suppliers, regulators and the community.

Governance

We take a fixed-income lens to Governance, and examine the oversight of the company's management and how well the incentives of managers are aligned with those of bondholders.

Measures & Materiality

With so many factors that relate to E, S and G currently capturing the headlines, it is easy to lose sight of which ones are truly important when it comes to credit risk.

For us to include a measure within our analysis, it needs to have the capacity to **materially affect credit risk** (MACR). Therefore, even if a measure is often cited with reference to E, S, or G, it is excluded from our approach if it does not have the capacity to materially affect credit risk.

An existing controversy around an issue is not enough by itself to warrant inclusion as a measure. To be incorporated in our scoring process, the issue must present an actual credit risk with the potential to have a material impact.

CreditSights ESG Rating Phases

Phase	Description
Determine Peer Groups	Determine Peer Group(s) from CreditSights coverage sectors
Agree on Category Weightings	Establish weightings for E, S, and G categories
Identify and Weight Measures	Identify and weight Measures that have the ability to materially impact credit risk
Assign Measure Scores	Score each Measure in the context of credit risk
Calculate ESG Scores	Calculate composite ESG scores for issuer, as well as category E, S, & G scores

Peer Group

Importantly, not all ESG factors are important to all credits. Fossil fuel emissions have less capacity to drive credit risk for real estate companies than for utilities. Our aim is to ensure that the selected ESG measures are relevant across all of the issuers within the selected 'Peer Group', and that their level of disclosure is consistent. Therefore, we sometimes divide sectors geographically, by investment-grade and high-yield, and even along business lines in some cases.

Universal & Discretionary Measures

To be as consistent as possible in the measures we have selected, we have where possible decided to make some Measures universally applicable across all sectors.

Those factors are all in the Governance bucket. These are:

1. Whether CEO Compensation means they are incentivized in a way that is poorly aligned with interests of bondholders.
2. Whether the Chairman/CEO Role is split or combined can have implications for oversight of the CEO and management by the board.
3. Similar to the Chairman/CEO split, a larger number of independent directors offers greater independent oversight of management decisions while bringing more independent perspectives to bear on governance issues.

We also include these **Discretionary Governance Measures**, where there is widespread, but not universal, applicability:

1. **Shareholder Rewards.** Are cash distributions (via special dividends or share buybacks) to shareholders potentially detrimental to creditors?
2. **Concentrated Ownership.** Does a family-controlling stake, a lack of listing or government link pose risks (or possibly benefits) for bondholders?
3. **Activist/Private Equity Ownership.** Do activist shareholders or private equity potentially present material credit risk for bondholders?
4. **Reporting Quality.** Do we have concerns about the quality of reporting around, for example, reported EBITDA, balance sheet clarity or segment reporting?

Scoring

Once we have determined the appropriate measures and peer group, we score the companies. First, we ensure that we are normalizing the data by an appropriate comparator. Second, we consider whether any two selected measures are in fact capturing the same underlying risk and therefore duplicative. The normalized measures are then converted into a 1 to 5 score (1 being the greatest risk, 5 the least) by considering them along a spectrum of risk:

CreditSights ESG Rating Phases (scale)

Description

Cumulative ESG effect is **entirely positive** from a fundamental impact perspective

Cumulative ESG effect is substantially positive from a fundamental impact perspective

Cumulative ESG effect is neutral from a fundamental perspective*

*no positive or negative impacts

Cumulative ESG effect is substantially negative from a fundamental perspective

Cumulative ESG effect is **entirely negative** from a fundamental perspective

Weighting

Finally, a weighting is assigned to each measure based on our analysts' assessment of the risks facing their companies. The E, S and G categories themselves are then separately weighted to roll up to an overall ESG weighting of 100%. Every measure has a weighting that represents at least 5% of the overall ESG score. The category weightings for a peer group are driven by the relative risk that our analysts see and can vary significantly across peer groups.

For example, in the REIT sector, the oversight of management and how well CEO and bondholder interests are aligned is more important in terms of credit risk than environmental or social concerns. In contrast, utilities have a high degree of exposure to environmental credit risks. As such, these two peer groups have very different weights placed on their E and G buckets.

	REITs	Utilities
Category	**Weighting**	**Weighting**
Environmental	10%	60%
Social	50%	20%
Governance	40%	40%

CreditSights ESG Trajectory Ratings

As issuers increasingly invest in steps to improve their performance on key ESG issues, a large difference can exist between their current performance on ESG risk factors and where it is likely to perform in a few years. CreditSights ESG Trajectory Score allows our analysts to assess the likely path for an issuer over the next 24 months.

CreditSights ESG Disclosure Scores

Finally, vast variation exists in the quality and quantity of ESG-related disclosure across issuers, sectors and regions. To highlight areas where we feel a more complete assessment of E, S and G risks requires more information, we offer CreditSights ESG Disclosure scores. We hope that publishing these scores might also encourage better disclosure in these areas.

About CreditSights

CreditSights empowers nearly 15,000 financial professionals among the world's largest institutions with the credit risk tools, independent research and comprehensive market insights they need to make well-informed decisions. Setting the standard for global credit research since 2000, we provide timely data, news, recommendations and unbiased analysis of the investment grade and high yield debt securities of 1,200+ issuers around the world. We deliver this content through innovative platforms, enabling market participants to know more, risk better and ultimately create value.

TO LEARN MORE ABOUT EMBEDDING ESG INTO YOUR CREDIT RISK ASSESSMENTS, CONTACT US.

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