ESG IN CREDIT RISK AND RATINGS:

ARE THE TCFD RECOMMENDATIONS USEFUL FOR CREDIT RISK ANALYSIS?

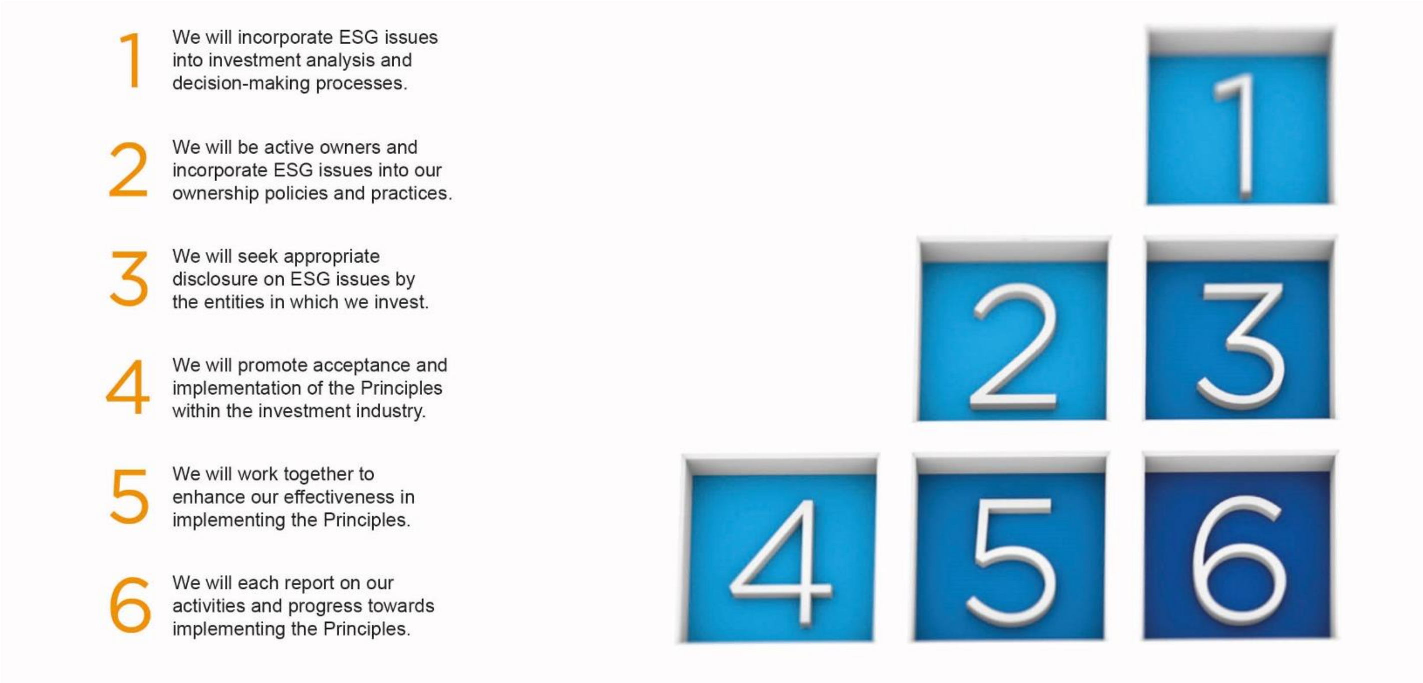
The ESG in Credit Risk and Ratings Initiative is funded by the Gordon and Betty Moore Foundation through the Finance Hub, which was created to advance sustainable finance.

An investor initiative in partnership with UNEP Finance Inititaive and UN Global Compact

THE SIX PRINCIPLES

PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:



1 We will incorporate ESG issues into investment analysis and decision-making processes.

2 We will be active owners and incorporate ESG issues into our ownership policies and practices.

3 We will seek appropriate disclosure on ESG issues by the entities in which we invest.

4 We will promote acceptance and implementation of the Principles within the investment industry.

5 We will work together to enhance our effectiveness in implementing the Principles.

6 We will each report on our activities and progress towards implementing the Principles.

PRI'S MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

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Fixed income investors and credit risk agencies (CRAs) have started to use the information disclosed by companies following the Taskforce on Climate-related Financial Disclosures (TCFD) recommendations to inform their credit risk analysis and issuer engagement.

There is a growing recognition among them that climate-related financial disclosures should be embedded in bond valuations and that climate change can impact issuers' probability of default.

This is an important development and contrasts starkly with 2015, when the TCFD framework was launched and responsible investment was not yet widespread among fixed income investors.

Alongside data on metrics and targets, disclosures on how companies identify, manage and integrate climate-related risks are now considered to be crucial, according to the asset owners, investment managers and CRAs we surveyed in 2021 as part of the ESG in Credit Risk and Ratings Initiative (see Appendix for survey details).

However, more consistent, standardised, sector-specific and forward-looking disclosures are needed.

Investors and CRAs highlight the need to address data gaps and the lack of harmonisation between sectors, to help them better incorporate risk management disclosures into their analysis qualitatively and quantitatively.

This article presents the findings of our survey, with a focus on credit risk assessments. It also aims to shift the focus of market participants from how TCFD-related information is prepared and disclosed to how it is used.

USING CLIMATE-RELATED FINANCIAL DISCLOSURES

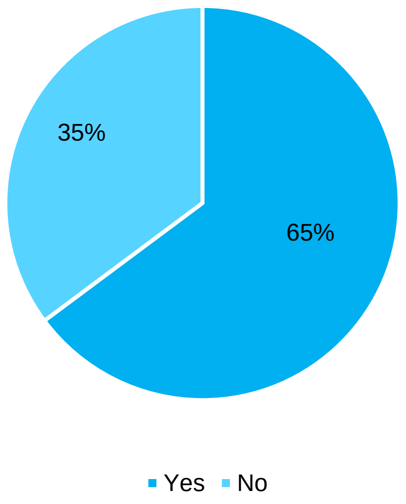
For 65% of respondents, the information provided by issuers as part of the TCFD's recommended disclosures has changed the way they conduct credit risk analysis.

Most companies are at an early stage in their reporting and asset owners and investment managers are still determining how to use the information provided, but they recognise that consistent, material, climate-related data allows climate-related risks and opportunities to be formally assessed and integrated into their investment processes.

Some investment managers are now including climate-related disclosures in their in-house ESG scoring systems.

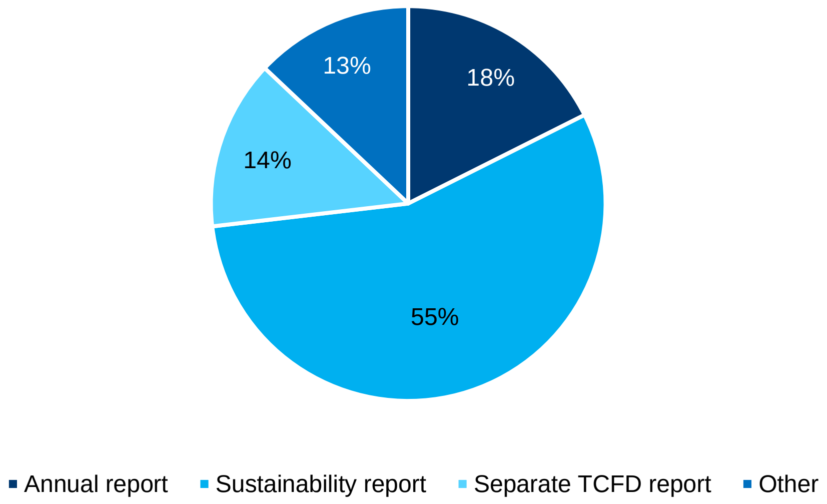
CRAs say that the TCFD framework has not significantly affected their credit ratings but has encouraged analysts to incorporate the impact of carbon pricing, such as carbon taxes and emissions trading schemes, in their corporate profit calculations.

Figure 1: Has the company information provided as part of the TCFD recommendations changed the way you conduct credit risk analysis?



More than two-thirds of respondents say that companies disclose TCFD-relevant information in sustainability reports or specific TCFD reports. Only 18% say they find TCFD-related information integrated in annual reports, while the remaining 13% use third-party providers or directly engage with the issuers to access this data.[1]

Figure 2: Where do you usually find information disclosed by companies as part of the TCFD recommendations?



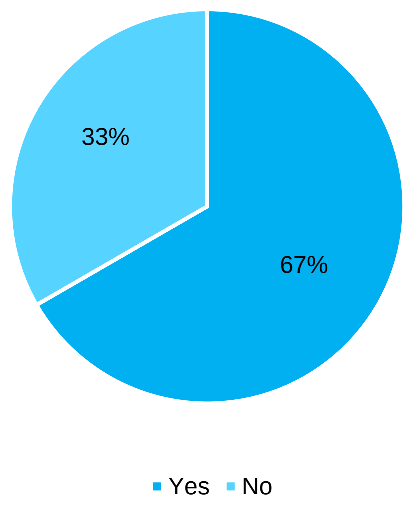
Two-thirds of respondents use the information provided as part of the TCFD recommendations to engage with issuers, directly or through collaborative initiatives (e.g. Climate Action 100+).

[1] Based on respondents' free-text answers, which they had to provide when selecting 'Other' as a response.

Engagement is usually conducted by credit analysts/portfolio managers, ESG specialists, or is shared between these roles. Where relevant and if the company is advanced and mature enough, respondents will discuss scenario analysis alongside risk management and metrics and target disclosures.

The 33% that do not engage say they speak with issuers on other topics instead, or that they are still considering whether to do so (due to inconsistent company disclosures and a lack of internal resources).

Figure 3: Do you use the information provided as part of the TCFD recommendations to engage with issuers?



ASSESSING THE MATERIALITY OF METRICS AND TARGETS

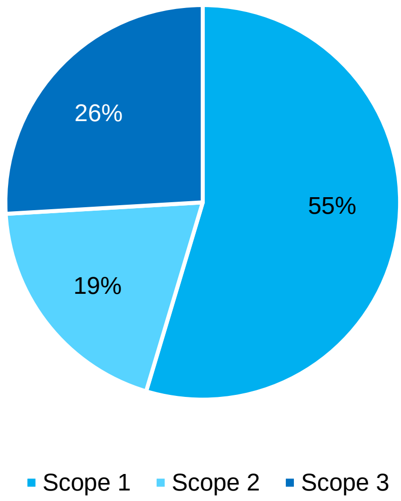
The TCFD recommends that companies disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

When asked what the most important disclosure metrics for credit risk assessment were, most respondents mention greenhouse gas (GHG) emissions and intensity as crucial.

Half report that Scope 1 emission metrics are the most helpful currently, as Scope 2 and 3 emission metrics lack good quality data. The proportion of capital expenditure or revenues allocated to climate-related solutions – including renewable energies – is also cited as material.

Some respondents add that the introduction of sector-specific metrics (e.g. GHG emissions per unit of steel production for mining companies) would also help inform credit risk analysis.

Figure 4: Which one of the three scopes of emissions helps you the most with your credit analysis?



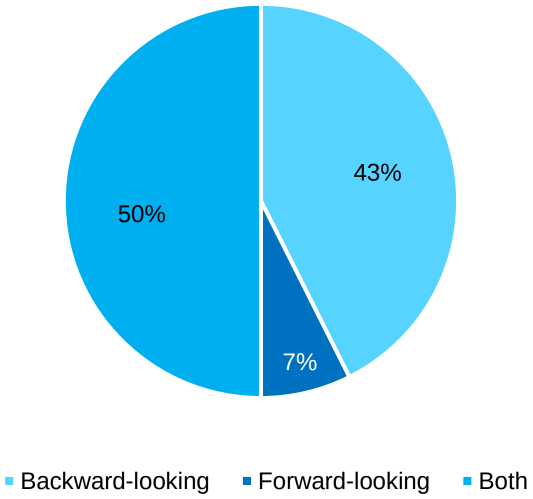
Developing more standardised, industry-focused metrics would partly address the lack of comparability between companies' disclosures – highlighted by close to half of responding asset owners, investment managers and CRAs.

Whilst metrics within the same industry can be compared if they are standardised, such as carbon emissions within the utilities sector, those from different sectors cannot be, due to differing calculation methodologies and a lack of good quality data. Some respondents hope that the EU Taxonomy will provide harmonisation.

Around 43% of respondents say that companies only disclose backward-looking metrics, while half report them disclosing a mix of retrospective and forward-looking metrics. This is common for companies across all sectors, as the metrics reported are generally based on the past financial year.

However, organisations are increasingly disclosing their future targets as well, which investors and CRAs encourage as part of their engagement efforts.

Figure 5: Do you think the metrics disclosed are backward-looking, forward-looking or both?



The relevance of climate-related targets for credit risk assessment depends on an issuer's risk and opportunity profile, respondents note. The majority agree on the importance of GHG emission reduction targets in absolute and intensity terms, for all scopes, as well as net-zero targets by 2050.

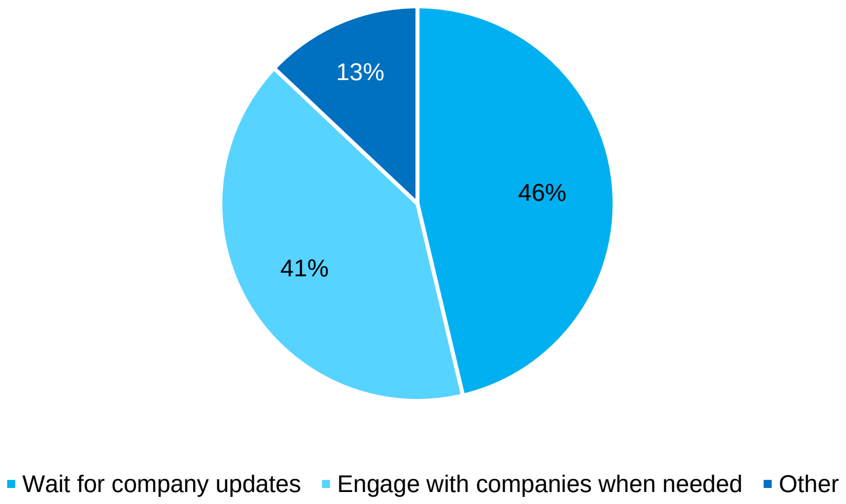
Contributing to the Sustainable Development Goals (SDGs) and meeting targets related to mitigating the risk of stranded assets are also cited as relevant.

As with metrics, respondents express the need for sector-specific targets (e.g. water risk reduction targets for water-intensive businesses or with operations in water stressed areas, such as clothing manufacturers).

When asked about how they monitor performance against targets, 46% of respondents say they wait for companies to provide updates, for example in their annual reports, while 41% actively engage with them. The remaining 13% say that they do both.[2]

[2] Based on respondents' free-text answers, which they had to provide when selecting Other as a response.

Figure 6: How do you monitor the companies' performance/progress against these targets?



HIGHLIGHTING THE IMPORTANCE OF RISK MANAGEMENT DISCLOSURES

The TCFD guidance recommends that companies disclose how they identify, manage and incorporate climate-related risks into their strategy and operations.

Respondents were asked to rank these disclosures by relevance for credit risk analysis – 26% agree on the following ranking:

1 – Identification
2 – Management
3 – Integration

Conversely, 15% concur with the below order:
1 – Integration
2 – Management
3 – Identification

Another 16% categorise all three types of disclosures as equally relevant.[3]

More than half of respondents agree that companies disclosing how they identify climate-related risks is an important first step, even where they have not yet identified how these will be managed and integrated into their strategies and operations – often the case with smaller or privately held issuers.

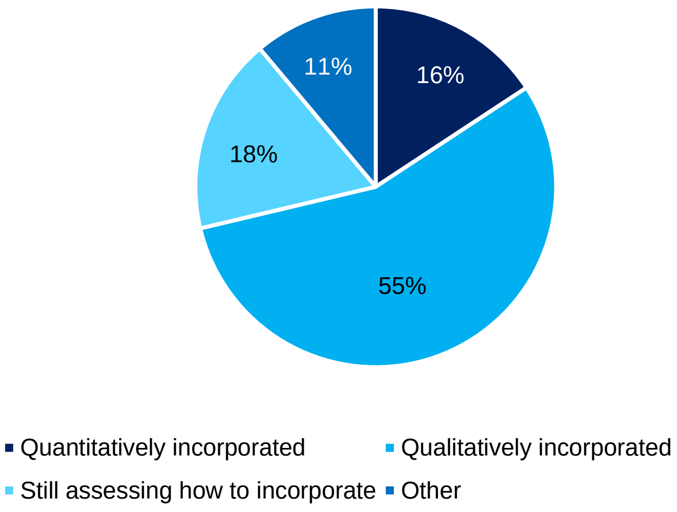
[3] A very limited number of respondents selected other combinations. We decided not to present them due to their sample size.

Beyond identification, respondents comment that companies need to integrate these disclosures into their overall risk management processes to ensure that climate-related topics are prioritised by management.

So far, respondents have largely managed to incorporate risk management disclosures into their analysis on a qualitative rather than quantitative basis. This is due to data gaps and a lack of standardised information from companies, and because some investors do not have the time or resources to conduct the quantitative analysis required.

A small proportion (11%) have started to incorporate these disclosures quantitatively and qualitatively.[4]

Figure 7: How do risk management disclosures inform your analysis?



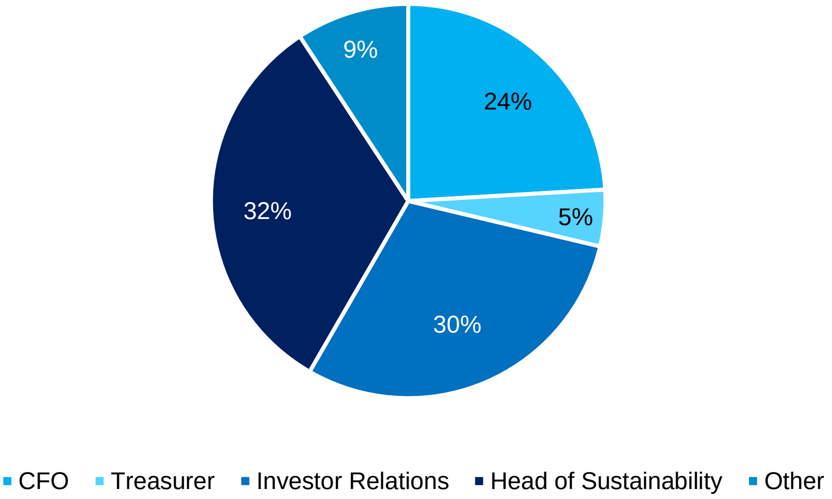
As previously noted (see Using climate-related financial disclosures), a large majority of respondents use disclosed metrics to engage with issuers.

Depending on the company's internal structure and the sector it operates in, its investor relations representatives and sustainability heads are most likely to speak with investors on TCFD-related topics.

In some cases, the finance function – especially the Chief Financial Officer – is involved in discussing the strategic and financial implications of climate risk. Having access to the Chief Executive Officer of smaller companies is crucial for investors and CRAs.

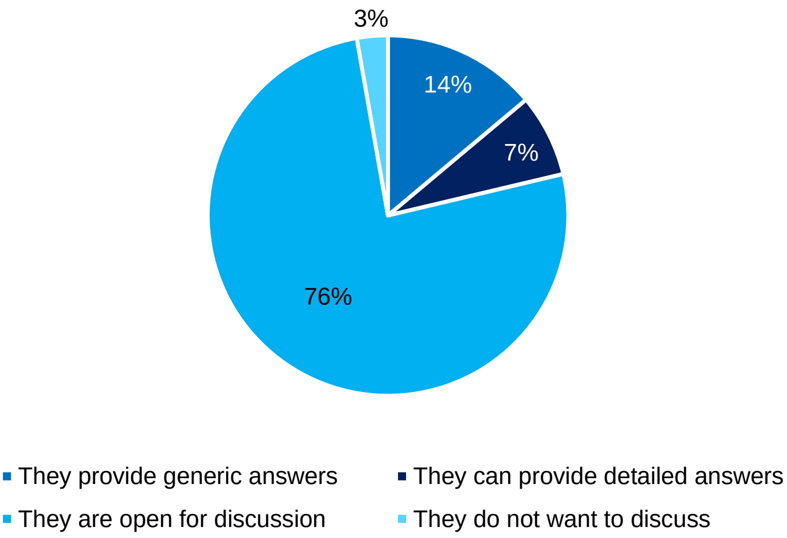
[4] Based on respondents' free-text answers, which they had to provide when selecting Other as a response.

Figure 8: Who is the company representative you engage with to discuss credit-relevant climate-related disclosures?



Just over three-quarters of respondents say that when they ask TCFD-related questions, companies are open to having discussions but are at an early stage of framing their responses on the topic. Very few issuers (3%) do not want to have a discussion, while 14% and 7% say companies can provide generic and detailed answers respectively.

Figure 9: How do companies react when you ask TCFD-related questions?



CONCLUSION

A lot of the work that has been done on the TCFD recommendations focuses on the companies that disclose information (the preparers), rather than considering the perspective of those utilising the disclosed information (the users).[5]

As such, we conducted this survey to assess the extent to which fixed income investors have begun to use climate-related metrics and targets to inform credit risk analysis.

These results will add to the work that we are already doing with corporate borrowers through the workshop series Bringing credit analysts and issuers together, where we convene investors, CRAs and companies to discuss the materiality of credit-relevant ESG factors across sectors and companies.

[5] As explained in the 2021 TCFD Status Report, the term preparer refers to any organisation that discloses climate-related financial information. The term user refers primarily to investors, lenders, or insurance underwriters, though other market participants such as CRAs and regulatory authorities also use the information disclosed. Many users are also preparers of their own disclosures.

APPENDIX

ABOUT THE SURVEY

We surveyed credit analysts from asset owners, investment managers and CRAs between March and June 2021 to assess how they use the information disclosed by companies as part of the TCFD recommendations on risk management and metrics and targets. We received 108 responses, from 17 asset owners, 75 investment managers and 16 CRAs.

Figure 10: Respondent categories

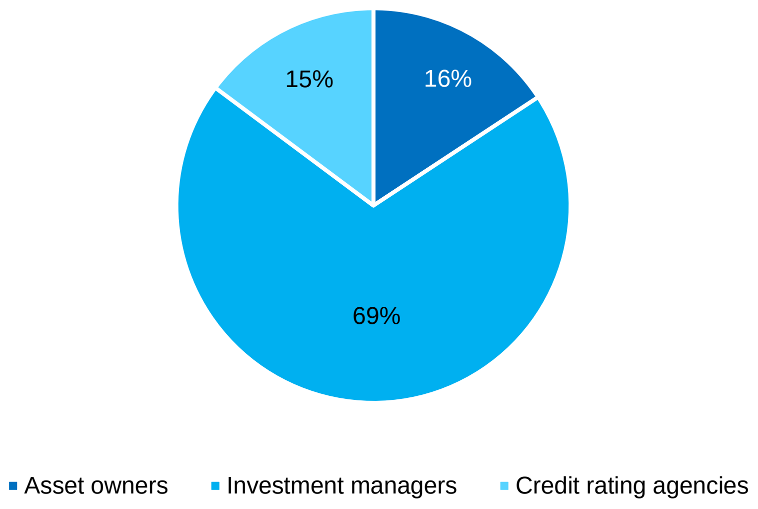
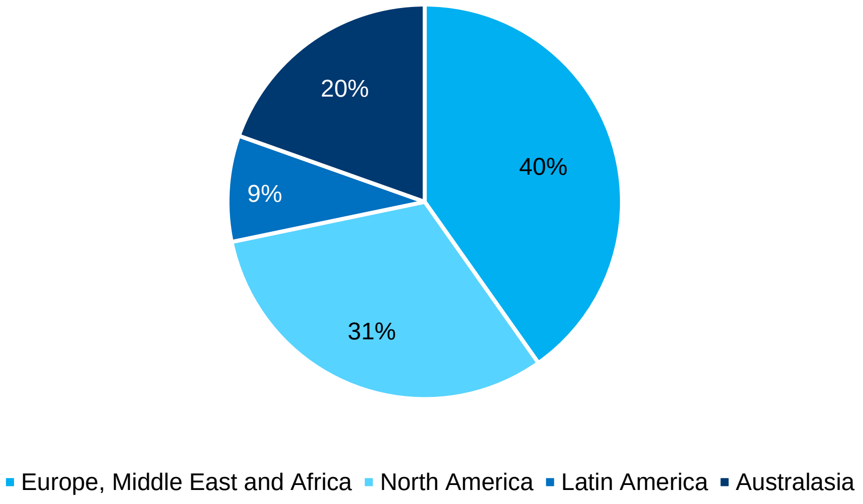


Figure 11: Geographical exposure of asset owners and investment managers



ABOUT THE TCFD

Launched in 2015, the Taskforce on Climate-related Financial Disclosures (TCFD) aimed to develop voluntary, consistent climate-related financial risk disclosure recommendations for companies to use when providing information to investors, lenders, insurers, and other stakeholders.

Since then, governments and regulatory bodies globally have taken action – for example, in 2020, New Zealand became the first country to introduce mandatory disclosure against the TCFD recommendations for organisations across the financial system.

The UK has announced its intention to make TCFD-aligned climate disclosures mandatory by 2025. Last year, the UK Financial Conduct Authority (FCA) issued a consultation, which the PRI responded to. Among other things, the FCA was seeking views from market participants on whether to apply the TCFD recommendations to issuers of standard-listed debt (and debt-like) securities, and how best to do this. The regulator will publish a feedback statement in the first half of 2022.

The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org