ESG IN CREDIT RISK AND RATINGS: BRINGING ANALYSTS AND ISSUERS TOGETHER

Sub-Investment Grade Borrower Workshop – Part 1

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.

NOTES FROM THE WORKSHOP

The PRI's ESG in credit risk and ratings initiative is for the first time bringing voices from the corporate side into the conversation on how to better integrate environmental, social and governance (EGS) factors into credit risk analysis. This article summarises the key points from the second in a series of workshops bringing together buy-side and sell-side credit analysts, representatives of credit rating agencies (CRAs), corporate finance and investor relations teams. The workshop, held in collaboration with the European Leveraged Finance Association (ELFA), follows a series of 21 PRI-organised forums between September 2017 and September 2019 to nurture an investor-CRA dialogue to promote a transparent and systematic consideration of ESG factors in credit risk assessment.[1]

Following the first Paris workshop, which involved four investment grade (IG) companies, this second credit analyst-issuer event focussed on sub-IG (high-yield) borrowers. In engaging with these companies, we explored the extent to which their credit rating impacts how ESG factors are considered in their business models and in investor assessments, alongside specific challenges facing financial market practitioners in this segment of the market.

The 29 September 2020 workshop was hosted in collaboration with the ELFA, reflecting synergies between the PRI's ESG in credit risk and ratings initiative and the ELFA's ESG disclosure initiative.[2] There were six discussion groups involving 13 sub-IG companies, representing the debt repurchasing, healthcare, telecoms and paper and packaging industries (see Table 1). In each group, there was also an analyst from a credit rating agency (Fitch Ratings, Moody's Investors Service or S&P Global Ratings) and between five and nine investors (36 investor participants in total from 31 organisations). The event was online. The discussion was held under Chatham House Rule and was informed by the guidelines that the PRI published after the Paris workshop.

Table 1. Participating sub-IG borrowers

Sector	Companies
Debt repurchasers	Anacap, Arrow Global, Cabot Financial, Intrum
Healthcare	Stada
Paper and packaging	Fedrigoni, Sappi
Telecoms	Eir, Liberty Global, Masmovil, TalkTalk, TDC, TeleColumbus

Among key points to emerge from the discussion, the main limiting factors in the degree of incorporation of ESG topics in loan and bond analysis are the size of the company and whether the company is publicly listed, rather than a company's credit rating. These two factors have a significant impact on levels of ESG data disclosure. Smaller companies have fewer resources to collect and disclose on these topics, while private companies are not subject to the same disclosure requirements

[1] All the findings of the forum discussions and recommendations for future actions are documented in the publication series '*Shifting perceptions: ESG, credit risk and ratings*' available at www.unpri.org/credit-ratings.
[2] The ELFA is joined in this initiative by the Loan Market Association (LMA).

as public companies. Still, the high-yield borrowers attending the event said they had been considering ESG factors and responding to investors and ESG information providers' requests for some time. Indeed, some have been working on ESG disclosure, as well as addressing sustainability topics in their business strategies, for several years.

Several observations made in this workshop echoed themes highlighted by IG companies in Paris, while others were new and enriched the debate, or were sector specific. Similarly to the previous note, the discussion findings are grouped in four main areas, with data challenges and disclosure more in focus this time.

1. COMMUNICATION: MORE REGULAR ENGAGEMENT IS KEY

All six discussion tables agreed that communication is key, echoing the sentiment expressed in the Paris workshop. Because the market is still in the early stages of complementing traditional financial analysis with specific, additive ESG analysis, participants agreed that engaging more closely on ESG topics is critical both for credit analysts and companies. This engagement should serve both to identify the most relevant information and to facilitate its effective delivery. Participants viewed the workshop as a good opportunity to initiate these conversations.

As a first step, credit analysts and issuers should seek to agree on credit-relevant reporting parameters. A dialogue is useful for both borrowers and investors:

- For borrowers - to better explain to credit analysts how they operate, what ESG factors they consider and how they prioritise data to disclose. Considerations might encompass differing stakeholder demands, confidentiality or commercial factors, and issues such as costs and resources.
- For investors - to improve their understanding of how materiality of ESG factors varies by sector and company. Also, to ask more pertinent questions and to 'educate' issuers about why their ESG demands are increasing, particularly in light of regulatory changes. These changes could have important implications, not currently fully appreciated[3], for companies' 'investability'.

Workshop participants noted that it would be useful for companies to adopt a standardised approach to communication and disclosure, so that analysts are able to collect comparable data sets based on mutually agreed metrics. They recognised, however, that data standardisation is extremely challenging and is likely to develop over time.

Corporate representatives highlighted a correlation between resources and the effectiveness of communication, with larger companies able to assign more dedicated full-time employees to gather

[3] See the Regulation (EU) 2019/2088 of the European Parliament and of the Council on Sustainability related disclosure in the financial services sector, 27 November 2019. The regulation applies to asset managers at the company level and in respect to any financial product offered, irrespective of whether the product has an ESG focus.

and disseminate ESG information, while smaller enterprises - the majority in the leveraged finance market - often rely on fewer employees who may have also significant other duties.

“The concern is that companies publish glossy policy documents with limited data to back up ESG claims & targets.”

Several analysts noted that senior management buy-in was a critical driver of communication and transparency. Corporate leaders committed to effective communication are able to provide higher-quality and more consistent information. However, the perceived lack of connection between increased ESG transparency (including disclosure) and funding costs can create challenges in securing board-level support. Participants discussed the importance of tying executive remuneration to ESG performance as a first step in assigning responsibility and promoting accountability.

2. MATERIALITY: SEPARATING THE WHEAT FROM THE CHAFF

The financial materiality of ESG factors was recognised as a critical component of risk assessment, though participants acknowledged that challenges remained in determining materiality.

“It is necessary to reassess materiality periodically - as situations change - to check if the analysis still holds.”

Decisions on materiality vary significantly by sector. For example, the healthcare, telecoms and debt repurchaser sessions highlighted that social factors were more relevant than environmental factors, Conversely, paper and packaging group discussions focussed on environmental factors.

ESG factors also vary by company, depending on the specific business model. For example, in telecoms, ESG metrics may be material or immaterial depending on the specific position of the company in the value chain (for example, whether a company builds infrastructure or is a wholesale carrier). Furthermore, companies have differing the level of awareness of ESG risks and preparedness to address them. As one CRA representative noted, the ‘holy grail’ is understanding the right metrics and to focus on a comprehensive balance of risk assessment, rather than on a single score.

Finally, materiality considerations also differ with respect to stakeholders (including customers, the various elements of a supply chain, investors and regulators) and time horizons (for example, a climate-related issues, such as reaching carbon neutrality by 2050, are unlikely to affect the risk assessment of a five-year bond). They materiality assessment is also dynamic, as it can change over time.

Some participants noted that there was distinction to be made between a material disclosure and ‘required disclosure’; that is, disclosure driven by regulatory obligations. Regulatory disclosure may concern information not deemed highly material for a specific company or sector. For example, companies could soon be asked to measure and disclose their carbon footprints (including Scope 3 emissions, which remain problematic), as the number of countries targeting net-zero greenhouse gas (GHG) emissions over the next 25-30 years is growing (including France and the UK).[4] Furthermore, the group discussed the need to try to tie materiality assessments more firmly to measurable outcomes or benchmarks such as the UN Sustainable Development Goals (SDGs).

Participants also commented on the need to credibly demonstrate how operational processes address ESG issues. There was broad support for more education and training across organisations, so that employees understand how their daily activities relate to the company’s ESG status. Furthermore, investors indicated that they would look for companies to incorporate ESG accountability from the board level down, with linked targets and compensation.

“Does ESG go to board level? Do directors and senior management have ESG factors written into their compensation factors? Investors want to see companies living ESG.”

Credit analyst participants highlighted governance as a key factor in the analysis of corporate processes and behaviours. In fact, a CRA representative noted that governance in 2019 was by far the most frequently material issue in the estimated one third of rating actions that had ESG factors as key drivers.

“Investors need disclosure of where the company is now and where it is going to credibly show how it is managing ESG risks...If companies do not address ESG, we see it as a material risk factor.”

Participants generally agreed that, while third party provider solutions were at times helpful in assessing materiality, they were seldom sufficient to be effective on their own. Given the complexities involved, companies often work with third party providers, but even with this support the process can be arduous.

[4] See https://www.nsenergybusiness.com/news/countries-net-zero-emissions/

3. DATA CHALLENGES: HOW TO COLLECT AND WHAT TO DISCLOSE?

Both corporates and credit analysts agreed that, while data were a key enabler of insight, challenges remained in respect of their availability, quality and comparability. In addition, participants agreed that more disclosure was required on ESG topics, with both companies and investors seeking standardisation in this area. Both groups expressed a desire for ESG disclosure to be incorporated into securities issuance processes and ongoing reporting.

Companies from all sectors noted that they were required to manage a significant number of ESG-related data requests, both from information providers and investors, with a sharp uptick in requests over the past 18 months. They stressed that a balance must be struck between the need for disclosure and allocation of resources, a particular issue in the sub-IG market segment. Investors noted, however, that forthcoming EU regulation may force them to start screening out companies that do not provide key information.

Corporate attendees reported that they often do not understand requests received from ESG data providers and are unclear over their role and utility. They reported that requests are often disconnected from the realities of the sector. Given that collection and transmission is resource intensive, this was a significant concern. Credit analysts noted that they do not widely use vendors' ESG scores but prefer to use data provided directly by issuers and undertake their own proprietary analysis.

"Issuers noted that it would be helpful if it were clearer what ESG issues they needed to report to investors and when."

Several participants cited the need for key performance indicators (KPIs) to enable higher levels of standardisation. According to some credit analysts, comparability is improving for individual companies, enhancing investors' ability to analyse ESG factors over time, but it is not improving within or between sectors. Participants also cited identifying quantification metrics, data availability, interpretation of reporting requirements, reporting periods, and geography-specific characteristics as factors that inhibit comparability.

Companies want to provide information but are often restrained by a lack of quantitative metrics, although some are emerging. For example, in respect of governance, data are available in relation to board composition, executive remuneration, diversity and inclusion numbers, and compliance frameworks (though they are standardised for listed companies but not for private companies).

"Corporates want to give information but don't know how. Some standards would be helpful, as investors and credit ratings agencies ask a lot of questions and corporates spend a lot of time and resources answering."

Echoing observations from the Paris workshop, participants noted the need for more effective dissemination of information. Company representatives said that they disclose significant ESG-relevant information through multiple reports, including annual and corporate social responsibility (CSR) reports. Indeed, in some geographies (notably Germany) non-financial reporting is now mandatory for some companies.[5]

Analysts, on the other hand, said they see the proliferation of information across various dissemination channels as an obstacle, and would prefer data to be harmonised and consistent. Still, participants did identify potential synergies between companies' existing regulatory disclosure requirements and the type of disclosure that investors wish to see; for instance, debt repurchasers already submit to the regulator records of customer complaints. As these are material to investors, from a governance and social perspective, the disclosure could be disseminated more broadly.

Workshop participants discussed potential transmission mechanisms for data disclosure and sharing. Several highlighted the benefits of involving legal counsels, so that data points could be incorporated into bond prospectuses or loan documentation.

To continue this discussion with key stakeholders, the PRI will host an event on 12 November 2020 with the ELFA involving company advisers, including law firms, sell-side banks, and private equity sponsors, together with senior fund managers and CRAs, to discuss the best ways to encourage ESG disclosure among sub-IG corporates. Company advisers interested in attending the event can contact Sabrina Fox, Executive Adviser to the ELFA, at sfox@elfainvestors.com.

4. SECTOR-SPECIFIC CONSIDERATIONS

As it was the case in the first workshop in Paris, the discussions highlighted several considerations specific to the industries represented. Indeed, investors and corporate borrowers agreed that a sector-level emphasis is vital to conduct a comprehensive analysis of financially-material ESG topics. Below we present a short selection of the specific factors and, where relevant, related KPIs that were discussed in each of the sector groups (see Table 2).

In addition, we are planning another event for sub-IG corporate borrowers and credit analysts, and intend to invite companies from the industrial, chemical, retail/consumer, and software/technology sectors. If you are a corporate borrower, or a credit analyst specialising in one of these sectors, and are interested in participating in this event, please contact Sabrina Fox, Executive Adviser to the ELFA, at sfox@elfainvestors.com or Carmen Nuzzo, Head of Fixed Income at the PRI, at carmen.nuzzo@unpri.org. We expect to host the workshop with the ELFA in the first half of 2021.

The PRI and ELFA intend to publish engagement and disclosure guides for investors and companies over the coming months, as the workshop series progresses.

[5] As of fiscal year 2017, the German CSR Directive Implementation Act makes non-financial disclosure mandatory for around 500 large companies.

Table 2. Sector-specific considerations

DEBT REPURCHASERS	HEALTHCARE
■ Social issues such as fair customer treatment, and privacy and data security important – analyst assessment typically qualitative ■ Relevance of point of contact systems and controls ■ Enabling investor access to complaints data ■ Comparability challenges, especially on collections data and reporting ■ Higher degree of standardisation of Estimated Remaining Collections (ERC) disclosure desirable for governance assessment	■ Need to differentiate based on sub-sectors ■ Social issues most material ■ Supply chain due diligence relatively advanced ■ Drug prices seen as a relevant social factor, impacting performance metrics ■ Opacity around some management practices ■ Substantial outsourcing presents challenges
PAPER AND PACKAGING	**TELECOMS**
■ Materiality analysis relatively well-developed ■ Supply chain impetus to disclose coming from different industries and large brands ■ Fibre, waste, energy supply, emissions and emission intensity in focus ■ Community impact important social factor ■ Governance more a geographical than a sectoral issue ■ Beginning to look at SDGs alignment	■ Governance overarching issue ■ Relevance of social factors (data security, privacy and cyber hacks) increasing ■ Supply chain risk significant ■ Becoming partners in the energy transition ■ Opportunities for SDG alignment increasing ■ Digital Inclusion

Keep up-to-date with the PRI's ESG in credit risk and ratings initiative and ELFA's ESG disclosure initiative