

Creditreform Rating AG

# The Impact of ESG Factors on Credit Ratings

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**Creditreform**   
**Rating**

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## 1 General Introduction

Sustainability is perhaps the most debated issue of the still young 21st century. What was originally understood as an ad hoc response to environmental accidents has become some sort of global movement that now covers more aspects than just environment, i.e. environmental, social and governance (ESG) issues.

Sustainable Finance has thus become widely spread during the last decade since it involves the integration of environmental, social and governance issues into the investment-decision-making process. By considering ESG factors across all rating objects, market participants will be able to identify risks that may have played a minor role in the past, and to discover new market potential. Furthermore, understanding their impact will enable investors to mitigate potential long-term risk drivers or benefit from opportunities arising.

On July 18, 2019, ESMA advised on credit rating sustainability issues and set disclosure requirements, thus implementing the European Commission action plan for sustainable finance, published on March 18, 2018. On ESG considerations, the guidelines “require greater transparency around whether ESG factors were a key driver of the credit rating action”<sup>1</sup>.

So far, Creditreform Rating has implicitly captured ESG considerations in its rating assessment process, with governance factors being the most representative aspects of its analysis. Going forward, however, „E“, „S“ and „G“ elements will be isolated in order to present in an insightful and more transparent manner the materiality and impact of these factors on our rating decision.

Against this backdrop, Creditreform Rating has established a general definition of the „E“, „S“ and „G“ dimensions, definitions which will serve as a general reference point across all rating objects in order to map the risks and chances that might be present in our ratings.

**Environmental issues:** A broad definition relates to all external conditions that jeopardize the quality and natural functioning of living and non-living matter. A specific approach, which

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<sup>1</sup> ESMA press release 18 July 2019 ESMA71-99-1199

is aligned with the environmental objectives set in the Taxonomy Regulation<sup>2</sup>, refers to how economic entities contribute to mitigate climate change, how effective they are with the use of natural resources and waste management, as well as how they do prevent pollution and protect ecosystems.

**Social issues:** In general terms, social issues refer to a fair and dignified treatment to human beings i.e. human rights. More specifically in a micro-economical manner, corporations' social considerations encompass the relationship with employees, communities, and third parties that form part of their operations. Thus, a corporate culture should foster an inclusive and equal treatment towards the construction of a developed society.

**Governance issues:** The broad concept of governance is associated with the internal and external practices through which entities are directed and controlled. In this regard, besides the set of rules and laws that determine business activity, relevant aspects such as management strategy, corporation structure, internal controls, and risk management should be highlighted. Accuracy and transparency of information, as well as unethical behaviour are challenges that economic actors have to deal with.

## 2 Product Related Approaches

### 2.1 Banks

ESG-related risks and opportunities are non-financial factors that might affect a bank's financial position. However, an appropriate assessment is necessary to create an awareness for these factors. ESG factors might lead to negative effects (e.g. reputation damage or loan losses, etc.), as well as positive effects such as costs reductions and diversification benefits.

Even though ESG risks and opportunities are indirectly embedded within our methodology, we consider that their isolation will provide further transparency and greater granularity of

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<sup>2</sup> EU Technical Expert Group on Sustainable Finance, 2019

information. Therefore, in order to assess the level of impact of these factors on banks, we pointed out ESG related risks and opportunities with regard to the banks' business activity.

As intermediaries between investors and capital seekers banks play a central role because of their opportunities to control investments. Due to the special features of financial institutions, material ESG aspects primarily arise from their ordinary loan and financing activities, which in turn are primarily determined by the banks' governance. We therefore assess the factor "Governance" the greatest importance as part of our banks' ESG analysis. However, the "Environmental" and "Social" factor might gain a special importance in certain cases as well.

In the following, we identify the focus of each ESG category and the relevance for the ESG analysis of a bank.

**Environment (E) factors within Bank Ratings:** Since banks' business activities are typically characterized by their lending operations, banks are usually exposed indirectly to environmental risks or opportunities through their loans but have an essential impact on the society through their ability to control investments. Under the "E" factor for banks, we understand and consider banks' financing and promoting activities which might have an impact on the environment. However, as part of the nature of banks' loan activities, extraordinary loan exposure to environmental risk is a relevant consideration factor as well. Moreover, resource efficiency comes along with a sustainable approach to the environment and is to be considered as an "E" factor within a bank's ESG analysis.

**Social (S) factors within Bank Ratings:** Given the bank's role as an economic actor and employer, banks face social risks and opportunities. Under the "S" factor for banks, we understand and consider banks' social external and internal responsibilities. External social responsibility can be reflected in the respect for human rights as well as other laws and regulations that serve and protect not only the bank's customers, but also every individual and the society in general. In addition, as part of internal social responsibilities of banks, we consider the bank's respect, appreciation and fair dealing with its employees as "S" factor within a bank's ESG analysis.

**Governance (G) factors within Bank Ratings:** Banks face governance risks and opportunities as other private economic actors. Under the "G" factor for banks, we understand and con-

sider banks' corporate governance and corporate behaviour, which might have a direct or indirect impact on the bank's performance. This consideration includes the suitability and sustainability of the management strategy as well as compliance with established laws. In addition, as part of the "G" factor we consider banks' business ethics, which goes beyond compliance with laws and rules and rather reflects a behaviour, which is in line with the moral views and shared beliefs of a society. Moreover, we appreciate the corporate transparency of the business conduct in the regard of the "G" factor, which is the basement for third parties to get an understanding of an entity's business conduct.

In Bank Ratings, ESG factors were already considered, in particular "Governance" as the most relevant ESG factor, when they were relevant rating drivers and had an impact on the bank's credit perspective. Therefore, no rating change is expected in considering these factors explicitly. For more transparency, Creditreform Rating will identify, outline and explain these factors as "E", "S", or "G" when they represent key rating drivers in the "ESG Impact Card".

An ESG analysis serves to provide transparency and greater granularity of information. Therefore, the ESG analysis examines and extracts ESG factors to present their impact on the credit rating of a bank. This additional information and consideration enables investors and interested market participants to consider ESG factors in their decision making process.

## 2.2 Corporates

ESG has established itself internationally in politics, society and the economy, and is invariably mentioned in the context of sustainability and responsibility. As part of the corporate credit rating, we use a specific card to address the ESG factors and to generally understand the aspects of "E", "S" and "G" as follows:

**Environment (E) factors within Corporate Ratings:** With regard to the environment, the sustainability aspect relates to business on the premise of preserving the earth and its biological diversity. This means working in a way that conserves the climate and resources and ideally maintains a natural environment by generating healing measures such as new technologies. Due to the fact that consumers and thus also politicians are becoming increasingly aware of environmental issues, it has also become a challenge to companies due to the financial risks

by monetary sanctions, for example through higher tax rates or falling demand. However, to ensure that the increasing risks are systematically taken into account, we assess different subject areas, for example the CO2 footprint, pollution rate, threats to biodiversity and others.

**Social (S) factors within Corporate Ratings:** We define the issue “social” as social responsibility, which includes respect to human rights, laws and regulations that serve to protect and fundamentally treat every single person or socially vulnerable group equally. Our thesis is that any breach could adversely influence the company’s performance or creditworthiness, while socially responsible actions should have a positive effect on the respective company. To identify the “S” factors, we examine in particular issues such as employee development, treatment of equal rights, labour rights abuses or human rights abuses, customer security, the general reputation of the company etc. and their financial consequences.

**Governance (G) factors within Corporate Ratings:** Governance is always an inherent part of corporate ratings as the quality of the company’s management or its actions have a direct impact on the company’s performance, its trustworthiness and its integrity. We assess “Governance” in the sense of good corporate governance by evaluating the management’s ability as well as a legal framework, which enables regulating the management and supervision of the company to achieve the highest possible coverage of the interests of its various stakeholders. For this purpose, we consider issues such as remuneration of the board of directors, structure of the board of directors, management skills and experience, management culture etc. This consideration includes the suitability and sustainability of the management strategy as well as compliance with established laws.

Creditreform Rating considers it necessary to analyse all three areas with generally equal priority in a corporate credit rating, in order to examine which aspects have or could have an impact on the creditworthiness of a company. Since the aim of the corporate credit rating is to determine credit risks as comprehensively as possible, factors in the “E”, “S” and “G” areas have always been indirectly considered as such in the rating process and are generally included in the credit rating, if they are relevant to the creditworthiness. For a long time, Creditreform Rating has also been using a questionnaire covering the “Governance” aspect due to its importance in its corporate credit ratings. Early 2020, Creditreform Rating revised and clarified the process of recording the ESG factors and their assessment, against the background of regulatory but also political and social developments, with the objective to achieve greater

transparency in the rating process by identifying and indicating if an “E”, “S” or “G” factor impacted the creditworthiness. Therefore, Creditreform Rating is now using specific “E”-, “S”-, and “G”-cards. The meaning and severity of the respective factor are determined and it is checked whether it is necessary to label it as a relevant ESG factor in the credit rating. As mentioned above, these aspects increased in importance in recent years, gradually affecting more companies in both positive and, above all, negative terms.

### 2.3 Institutional Investor Debt

The term ESG matters in varying degrees in all asset classes rated by Creditreform Rating in the context of Institutional Investor Debt (real estate, movables, infrastructure, renewable energies, private debt, etc.). For this reason, both the ESMA requirement and the increasing public discourse on the subject of sustainability suggest that a stronger demarcation and definition of the dimensions “E”, “S” and “G” is therefore advisable. The identification of the relevant ESG criteria is based on the previous Creditreform Rating Track Record in the respective asset classes in order to meet the representation and impact of ESG influences – which may occur in different forms and directions – for the area of Institutional Investor Debt. Depending on the asset class, the identified ESG criteria differ in their individual relevance. A uniform model was developed to ensure continuity across asset classes.

Because of the comprehensive consideration of the influencing factors relevant to the rating from the point of view of Creditreform Rating, ESG factors have already been reflected in the credit ratings in the past. In order to increase transparency though, it is now explicitly indicated at the appropriate point to what extent ESG factors as a whole have influenced the determination of the rating grade in the rating process. It is also revealed which ESG factors are considered by Creditreform Rating to have a particular influence on the rating grade.

**Environment (E) factors within Institutional Investor Debt:** As transactions are particularly exposed to environmental risks at the level of the respective asset class, this area focuses mainly on identifying environmental impacts that may affect the credit quality of the rated asset. This could result in negative impacts, such as additional project conditions, which may affect the project budget and thus the credit rating. In the opposite direction, low-emission

investment properties can be improved in their profitability through reduced carbon costs, which may have a positive impact on credit quality.

**Social (S) factors within Institutional Investor Debt:** Investment decisions always have an impact on society through the allocation of financial resources to the asset classes underlying the transactions. For example, within the framework of project financing, acceptance among the population can be promoted and at the same time, a positive social impact can be generated by involving citizens, authorities and other relevant parties in the project at an early stage, by giving them the opportunity to participate or by providing support services. Simultaneously, this can possibly reduce the probability of future resistance (e.g. through lawsuits), which in turn can have an impact on the profitability calculation and thus on credit quality.

**Governance (G) factors within Institutional Investor Debt:** From a profitability point of view, governance factors are an elementary building block for the operational performance of the assets concerned. Inadequate governance can have an indirect negative impact on the credit quality of the rated asset. For example, in the area of data protection, inadequate measures not only result in damage to reputation, but also give rise to monetary risks through legal sanctions.

## 2.4 Sovereigns

While there is no universal and commonly agreed typology or definition of ESG criteria, Creditreform Rating views ESG factors as an essential yardstick for assessing the sustainability of a state. We believe that the ESG dimensions have to be taken into account in policy-making and regulation in such a way as to support the achievement of three key objectives, namely sustainable and inclusive growth, the mitigation of environmental and social risks, and the promotion of long-term oriented financial and economic activities within an economy.

**Environment (E) factors within Sovereigns:** When speaking of environmental issues at the sovereign, or more generally, the public finance level, we refer to all ecological and climate-related risks and opportunities that arise from the environmental quality as reflected by air, water and forest conditions as well as challenges pertaining to climate change. Moreover, we

consider environmental externalities, i.e. a state's vulnerability to natural disasters and transition risks stemming from the shift towards a low-carbon economy. Finally, resource management also plays a pivotal role, in a sense that sovereign decision-makers shape the framework conditions for the use of natural resources and renewable energy sources, the security of supply, and the conservation of biodiversity.

**Social (S) factors within Sovereigns:** Social issues that are crucial at the sovereign level pertain to the risks and opportunities arising from the social structures and conditions that exist within a society and the extent to which they promote or hinder social cohesion and collective development. In this regard, we cover a broad range of factors that are deeply intertwined. Key aspects that reflect the abovementioned social risks and opportunities according to our conceptual delineation include labour, equality, education, and health. Furthermore, we take into account the demographic structure and trends as well as the technological infrastructure of the state. Last but not least, one has to be aware of the general safety and security of the population.

**Governance (G) factors within Sovereigns:** Governance is of utmost importance since institutions determine the rules of the game that affect or control the behaviour of interacting economic and financial entities in an economy. In this vein, the environmental and social performance of a state is essentially very closely related to governance issues, as a government makes policy choices to e.g. mitigate climate risks or protect fundamental freedoms of individuals. Ultimately, differences in economic and political institutions appear to explain much of the variation in economic growth and social welfare between countries. We conceptually split governance into the independence and effectiveness of the judicial system and the existence of property rights, the quality of public services and policies, the integrity of public officials, the quality and efficacy of regulations, as well as the degree of civil liberties and political participation.

Creditreform Rating has been carrying out sovereign ratings in accordance to its sovereign rating methodology since July 2016. From the very beginning, we have incorporated ESG factors into the decision-making process before arriving at a sovereign credit rating. Until recently, however, Creditreform Rating did not explicitly link the term ESG to statistical concepts, economic variables, and the evaluation of respective policies, which are taken into consideration in the course of our sovereign rating process.

Variables associated with the governance dimension are represented very prominently, as 'good governance' is one of the key risk factors analyzed by Creditreform Rating staff, incorporated into the risk factor "Institutional Structure". The willingness of a sovereign to honour its financial obligations is of central importance to our assessment of a sovereign issuer's creditworthiness, since the institutional framework significantly affects political decision processes and outcomes, and thus is a crucial element to consider when assessing the probability of a sovereign default. This framework is a constituent feature of governance, i.e. the execution of economic, political, and administrative powers to exercise the functions of government on all levels. Good governance ensures the long-term growth perspectives of an economy and prevents a sovereign's creditworthiness from significant deterioration.

Moreover, we also consider several aspects, which we relate to social issues as elaborated above. Social variables are largely reflected in our assessment of the risk factor "Macroeconomic Performance" and of the fiscal framework and challenges (i.e. "Fiscal Sustainability"). Thus, we assess several dimensions of demographics, the labour market situation, but also the government's support of social, health, and educational outcomes. In general, we regard an economy's GDP per capita (PPP terms) as a good proxy variable of wealth conditions and social well-being. High levels of per capita income are commonly associated with high levels of prosperity in the form of human capital or tangible and financial assets.

At this stage, environmental considerations are less represented in our sovereign rating methodology as compared to governance and social issues, since we view it as least correlated with sovereign default risk in the near to medium term. Having said this, our methodology does allow the inclusion of factors such as pollution, natural disasters, or water stress in our ratings. To be sure, we also incorporate some factors or indicators related to environmental issues in a wider sense. In evaluating fiscal policies and types of taxation, we also take a more in-depth look into the tax system of a sovereign, including the levels of environmental and growth-friendly taxes. Furthermore, when examining a country's economic resilience and flexibility, we take a closer look at the dependence on commodities, i.e. the share of natural resources rents to GDP, as well as the metal and agriculture share of exports.

That being said, we might attach a greater degree of attention to environmental aspects going forward. Firstly, the exposure to climate-related risks appears to have become more intense,

as indicated by the higher frequency of hazardous climate events. Secondly, availability, accuracy, and timeliness of environmental data is improving. Lastly, fundamental research on the impact of environmental (and to some degree, social) factors on credit risk seems to gain traction, although it is still in its infancy and more and internationally concerted effort is certainly needed.

## **2.5 Structured Finance**

ESG-related risks are non-financial factors that might potentially impact an entity's sustainability if they are not appropriately assessed. ESG factors might constitute both negative effects (e.g. dwindling revenues or even bankruptcy), as well as positive effects such as costs reduction, labour productivity i.e. corporate performance improvement.

Due to structured finance features, material ESG aspects might influence cash flows generation, since the latter are determined based on a pool of underlying assets. In the same manner, ESG considerations might affect structured finance transaction's rating decision given the relationship between the structured asset's issuer and its counterparties. Notwithstanding, during our rating process, besides the aspects that might directly affect the performance of a transaction, other risks emerging from an asset's exposure are taken into account as part of the analysis. Hence, we believe that environmental and social aspects are implicitly incorporated in our approach, emphasizing mainly on governance concerns. The distinction of ESG factors, however, is not clear-cut and definitions may overlap. For instance, environmentally pollutive business models/assets may cause risks in terms of social and regulatory consequences such as reputational damages or regulatory intervention.

Even though ESG events are indirectly embedded within our methodology, we consider that their isolation will provide further transparency and greater granularity of information. Therefore, in order to assess the level of impact of these factors on Structured Finance and Covered Bond transactions, we mapped ESG related risks in already existing ratings. Thus, a mapping was developed across our sub-sectors (Auto ABS, Covered Bonds, NPL, and Trade Receivables) to clearly identify what could be potential ESG aspects that might jeopardize a transaction's creditworthiness, as well as, determine what would be the possible impact on the credit rating.

Once listed the possible ESG risk factors, Creditreform Rating has classified them in subcategories, according to the effect on Structured Finance transactions and ESG definitions presented by our team. The magnitude of influence can vary widely for different asset classes. Therefore, Creditreform Rating uses different ESG templates to analyse its Structured Finance ratings.

**Environment (E) factors within Structured Finance:** Since Structured Finance transactions are collateralized by pools of underlying assets, the latter are exposed to environmental risks, or worse yet, generate environmental damage. The analysis of "E" factors is focused mainly on the identification of environmental events that might endanger both the parties involved in the transaction and the collateral, which could be detrimental to credit performance. For example, the regulation of the EU for reducing CO2 emission performance standards for new passenger cars and for new light commercial vehicles forces car manufacturers to further refine its car fleets as of 2021. On the one hand, this could put pressure on future residual values for outdated models; on the other hand, there is an uncertainty about the price stability of novel technologies (for example electric vehicles).

**Social (S) factors within Structured Finance:** Given that underlying assets predominantly consists of consumer-based receivables, social factors can play an important role in assessing the sustainability of Structured Finance transactions. Macroeconomic social indicators, for instance, might have a direct effect not only on the collateral, but also on counterparties, and consumers; effects that could be either positive or negative. Changes in labor legislation, as an example of macroeconomic aspects, might lead to structural shifts in the market, affecting consumer behavior. Such changes can have consequences in the payment conduct of clients, which if negative, might therefore impact cash flows over time.

**Governance (G) factors within Structured Finance:** Governance issues, in our opinion, constitute the most representative considerations when analyzing ESG in Structured Finance transactions, since most of them have been explicitly assessed and addressed in our rating reports. Covered Bonds, for example, are subject to strict legal requirements, where regulatory risk represents an essential aspect when assessing their creditworthiness. For example, the Spanish legal framework defines clear rules to mitigate risks, especially, regarding to in-

solvency remoteness, investor's special claim vis-à-vis other creditors, among other provisions. However, this country's legal framework does not stipulate a special cover pool monitor independent from the issuer.

In Structured Finance, ESG aspects were already considered in a credit perspective and they do not constitute potential rating drivers. Therefore, no rating change is expected in considering these factors explicitly. Even in cases where such considerations may be material in the credit rating, the impact can be absorbed by the transaction mitigants. Creditreform Rating will include a disclosure of the analysis of ESG factors, in which their significance and relevance on the rating decision will be mentioned.