ESG and credit rating agencies: The pressure accelerates

As environmental, social and governances themes become increasingly relevant in today's world, accelerated by the pandemic, rating agencies are paying more attention to them as far as rating methodologies are concerned. So far, ESG factors have mostly indirectly influenced ratings, but S&P's recent revision of the industry risk of oil & gas companies due to climate risks is a sign of the times ahead

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Rating agencies have integrated ESG factors into their rating methodologies

As the sustainability debate comes under increasing focus for a number of corporate sectors, credit rating agencies have not been able to escape this discussion either.

The pandemic has accelerated the importance of environmental, social and governance (ESG) themes, especially the social component, due to the impact on employees and civil society. Therefore, the three most prominent rating agencies, Standard & Poor's, Moody's and Fitch Ratings have each incorporated ESG themes into their credit rating methodologies in their own way.

The pandemic has increased the importance of ESG further and accelerated rating agencies' thinking in this area

In order to fully engage with the task, S&P and Moody's have both acquired entities that have brought ESG knowledge in-house. S&P bought Trucost - a provider of carbon and environmental data and risk analysis and in November 2019 the ESG rating business from RobecoSAM. Moody's has made a few acquisitions too including Vigeo Eiris, a global leader in ESG assessments, Four Twenty Seven, a publisher and provider of market intelligence on the economic risk of climate change, and SynTao Green Finance, a provider of ESG data and analytics-based in and serving China.

During the peak of the pandemic, the 'social' factor emerged prominently as a credit determining factor when health concerns and social distancing measures were having a direct impact on business activities. Also, there is an intensified focus on institutional preparedness for global risks and environmental as well as social factors including healthcare access and economic inequality.

Corporates face a time horizon mismatch paradox, as they have to prepare for ESG risks in the medium-to-long-term and short-to-medium-term capex and opex

That being said, corporates face a time horizon mismatch paradox. While they are increasingly urged to prepare for ESG risks in the medium-to-long-term, they also need to manage their credit ratings, which involves managing short-to-medium-term capex and opex and the hit that can have on 'traditional' credit metrics.

Unless carefully managed it could turn into a case of "damned if you do and damned if you don't"

So far, ESG factors haven't really been a direct component of issuers' final credit ratings

The way rating agencies have integrated ESG themes into their rating methodologies thus far has excluded these factors directly impacting credit ratings as isolated concepts.

Rather environmental, social and governance issues are considered in relation to the impact they have on corporates and their financial risk profiles. At the same time, fundamental credit factors such as financial flexibility, the strength of free cash flow generation and robust liquidity can limit or offset ESG risks, at least from a rating perspective, in particular environmental and social risks. In short, rating agencies' ESG analysis has so far complemented their overall credit rating analysis and will increasingly continue to do so.

Although not direct components, ESG impact on issuers' profile have led to rating actions

Although not standalone factors that drive issuers' credit ratings just yet, the assessment of ESG impact on the issuers' business and financial profiles have led to rating actions.

At Standard & Poor's, just above 30% of total rating actions in the corporate sector between April and December 2020 were affected by ESG factors, of which 14% were related to environmental issues. In 2019, 33% of Moody's rating actions in the private sector cited ESG factors as material credit considerations. Fitch has had around 25% of its ratings influenced by one or more high ESG impact scores of which around 3% had ESG as a key rating driver and 20% was related to governance considerations as of September 2020.

For example, S&P downgraded the credit rating of an automotive OEM company in April 2020 because of non-compliance issues with EU law on CO2 emissions targets which led to a fine and significantly reduced the issuer's financial flexibility in the middle of the pandemic. And we expect, more examples to follow.

33%

Private-sector rating action at Moody's in 2019 was influenced by ESG factors

of which 20% were related to social issue

The purpose of credit ratings is to assess the likelihood of a company to repay its debt. However, as ESG factors become increasingly important in the quality assessment of issuers, we believe these elements will see their importance swell over time.

Energy sector in the spotlight

On 27 January 2021, S&P placed a number of issuers part of the oil & gas industry on CreditWatch with negative implications.

The move concerned fifteen energy companies including a mix of European, North American and Chinese oil majors, on the basis of energy transition, price volatility, and weaker profitability. Although this major step could be interpreted as a shift in methodology, the revision actually reflects the application of the rating agency's current methodology.

The rating agency revised the industry risk for the industry to "moderately high" from "intermediate" in part because of the increased environmental threat posed by greenhouse gas emissions, evolving government policies and emission standards. Beyond the assessment revision that took into consideration the "challenges and uncertainties engendered by the energy transition, including market declines due to growth of renewables", the rating agency also looked into investments levels between 2005 and 2015, lower prices since 2014, and the recent volatility in the industry risk assessment.

Oil & gas industry risk changed to "Moderate High" partly because of increased environmental threats

Standard & Poor's is likely to follow-up on the CreditWatch negative implications soon. The energy players concerned are amongst the highest rated within the industry, but the rating agency believes these companies bear a significant increase in pressure from governments to respond to the energy transition and climate risk issues in general.

With special thanks to Julian Crush and Athanasios Smprinis, part of the ING Ratings Advisory team.

Author

Nadège Tillier
Head of Corporates Sector Strategy
nadege.tillier@ing.com

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