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Playing the ratings game in responsible investment

Environmental, social and governance (ESG) risks can have a clear impact on the creditworthiness of a company and be material for fixed income investors' portfolios. Here, the Insight Investment team explains why.

While ESG risks can be an important consideration for investors, those seeking to take them into account in their investment decisions can face some difficult questions. Even if you believe ESG analysis should be directly integrated within corporate bond research processes, there are challenges to overcome. Dealing with these challenges is difficult, though we believe it is possible.

The challenges for responsible investors

- **ESG risks are complex:** The different factors and risks covered by the single term 'ESG' are extensive and complex – ranging from how climate change might affect a company's supply chain, through to the political ramifications of upcoming regional elections, and the specific governance structures and processes of a corporate entity.

  These issues require time, knowledge and expertise to analyze, and to judge whether they are material for a company's creditworthiness.

- **Gaps exist across the market:** The lack of standardized ESG disclosures in many areas mean gaps exist and comparability can be a problem.

  For many smaller issuers, particularly emerging market or high-yield companies, the availability of relevant non-financial data lags information from larger issuers – investors must make a judgement call as to how to fill such gaps.

- **Different ESG data providers take a different view on these questions:** Each ESG data provider generates useful information, but different providers reflect different emphases.

  These factors result in variance in ESG ratings for the same entities (see below).

ESG ratings from different data providers can vary significantly[1]
For illustrative purposes only.

Issuer	ESG data provider 1	ESG data provider 2	ESG data provider 3
US energy company	4	2	4
APAC utilities company	4	5	3
US food retail company	3	2	4

[1] Insight Investment. As of September 30, 2021. Ratings range from 1 (best possible) to 5 (worst possible).

- **In our view, fixed income investors need to focus on default risk:** Default risk is the prism through which fixed income investors view potential investments, but the relevance of ESG factors to this risk can vary significantly across different sectors.

For example, health and safety, and carbon emissions, can be considered important risks for companies operating in the mining sector, but may be of generally lower importance for financial services companies. The exception is with corporate governance, where risks can form an important part of evaluation for every type of issuer and credit quality.

Crucially, the relevance of ESG risks can differ across different fixed income instruments from the same issuer, given varying structures and maturities. This can add another layer of complexity.

Fixed income markets encompass a wide range of issuers and instrument types. While the basic principles of a responsible investment approach will remain consistent across them, the practical implications will be different. For example, most analysis of ESG and sustainability risks has focused on corporate debt, with research into their impact on sovereign debt still in a developmental phase. Much of this is down to the availability of good quality data which is still more accessible at a corporate level.

The potential materiality of ESG risks is widely acknowledged. There are many examples of such risks having a material impact on the pricing of a bond, or leading issuers to default.

The Covid-19 pandemic highlighted the vulnerabilities of different sectors and industries and demonstrated the importance of a sharp focus on ESG risks. The focus on governance also intensified after the collapse of a leading German payments company, where revelations of over-indebtedness and reported incidences of fraud led to significant losses for many investors.

We believe investors need a systematic way of digesting the information from many sources to help make an informed view. ESG ratings, which aim to flag companies exposed to prominent and material risks, can play a clear role – but it needs to be clear how these ratings align with an investor's own opinion on ESG credit risk.

In our view, it is clear that to identify/manage ESG risks effectively, an investor needs to engage actively with issuers: both to understand the risks more clearly and how they are managed; and to encourage improvement where appropriate and necessary.

Further, we believe qualitative judgement is still necessary to understand the implications of ESG ratings, which can be a result of multiple intertwined and complex datapoints. It is also necessary to discern the specific data driving ratings – so analysts can then consider how a company's management may, or may not, be dealing with a specific risk.

Assessing the greenwash factor

While specific ESG risks such as health and safety, and carbon emissions are important to investors, markets can hide other less obvious perils.

A recent boom in responsible investment has seen the ESG credentials of some bond sellers coming into question, amid fears they are overstating their green credentials or 'greenwashing' their products[2] in order to attract investment while paying only lip service to responsible investment requirements.

[2] FT. Investors probe ESG credentials of bond sellers on 'greenwashing' fears. October 2, 2022.

While greenwashing isn't always necessarily a result of an issuer intentionally misleading people, the phenomenon has not gone unnoticed by policymakers and regulators. Various governments and intergovernmental agencies continue to find ways to identify and clampdown on the practice.

In June 2021, the UK-hosted G7 summit saw members secure an agreement to mandate climate disclosures across member economies by 2025. The G7 agreement aims to globally standardize the approach to ESG compliance to minimize greenwashing[3].

In turn, the European Union (EU) has said efforts to tackle greenwashing are among its three main priorities for sustainable finance work over the next three years[4]. Indeed, the introduction of the EU taxonomy regulation in June 2020 was partly designed to reduce fragmentation in sustainable financing practices and to prevent greenwashing in financial products[5]. Wider consultation with the European investment industry is ongoing in this area.

The EU's Sustainable Finance Disclosure Regulation (SFDR) also aims to channel €1trillion of funding into more sustainable sectors while guarding against greenwashing.[6] In the European Securities and Markets Authority (ESMA)'s new Sustainable Finance Roadmap 2022-2024 issued in February, tackling greenwashing and promoting transparency are among its key aims.

The European regulator says: "The combination of growing demand for ESG investments and rapidly evolving markets creates room for greenwashing. Greenwashing is a complex and multifaceted issue which takes various forms, has different causes and has potential to detrimentally impact investors looking to make sustainable investments. Investigating this issue, defining its fundamental features and addressing it with coordinated action across multiple sectors, finding common solutions across the EU, will be key to safeguarding investors."

ESMA has also published a call for evidence in order to provide a mapping of ESG rating providers operating in the EU. A separate European Commission consultation is looking to propose an initiative to foster the reliability, trust and comparability of ESG ratings by early 2023.

[3] FT Adviser. How US and UK regulators are targeting greenwashing. August 13, 2021.

[4] IPE. Greenwashing fight a priority for ESMA in new roadmap. February 14, 2022.

[5] Mondaq. European Union: ESG: Greenwashing And The EU Taxonomy Regulation - Part 1 - Greenwashing, What Is It? May 28, 2021.

[6] EUObserver. EU's anti-greenwashing laws enter into force. March 10, 2021.

Disclosure

All investments involve some level of risk, including loss of principal. Certain investments have specific or unique risks. No investment strategy or risk-management technique can guarantee results or eliminate risk in any market environment.

Recent market risks include pandemic risks related to COVID-19. The effects of COVID-19 have contributed to increased volatility in global markets and will likely affect certain countries, companies, industries and market sectors more dramatically than others.

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