ESG in Credit Ratings – General Considerations

Corporates, Financial Institutions, Covered Bonds, Project Finance, Sovereign and Public Sector, Structured Finance

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1. ESG in Credit Ratings

To include ESG considerations in credit ratings, we need to overcome two main challenges: accessing reliable, standardised data and selecting considerations that are credit relevant. This field is constantly evolving, and our rating methodologies are regularly updated to capture emerging industry trends.

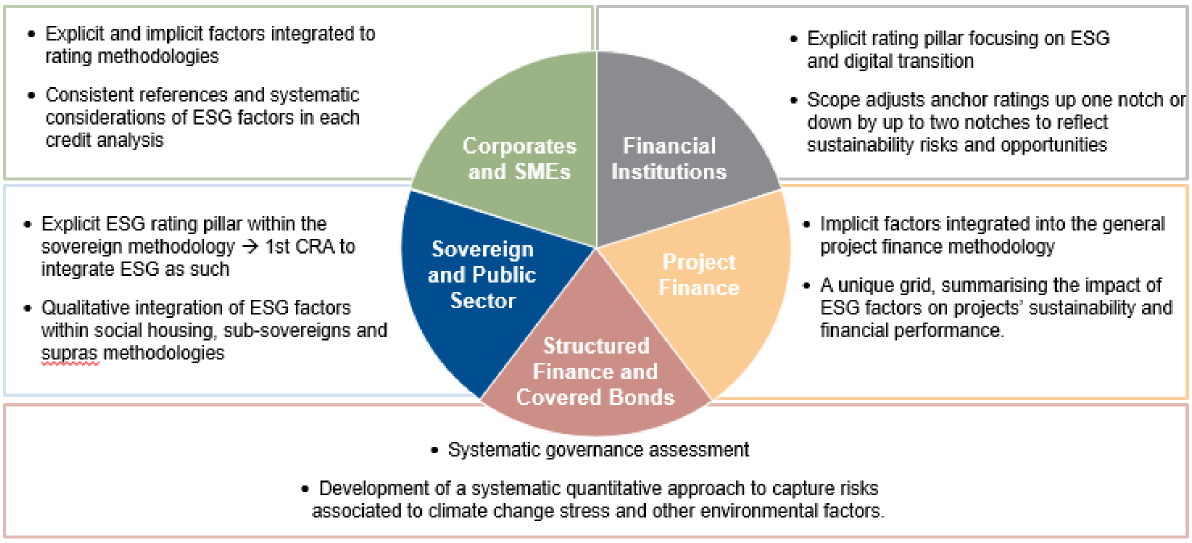
Our credit rating methodologies vary according to the asset class, industry or region as well as the capital and structural features of a financial instrument. Similarly, our assessment and the relevance of ESG factors is a function of the asset class, the industry or the region in question. Our methodologies define and use processes and topics depending on the asset class. The credit rating methodologies listed below (see section 2) provide the rating principles for each analytical area. They show how environmental, social and governance (ESG) factors can be credit relevant and provide systematic ways to identify and provide guidance on how ESG is incorporated into the rating analysis on a continuous basis. ESG factors need to be seen in the context of our rating definitions either as generally defined in Scope Ratings' definitions or the respective practice specific Credit Rating methodologies[1].

In general, our forward-looking opinions regarding the relative creditworthiness of an issuer, an instrument, or an obligation, address the timely payment or expected loss for financial obligations. They blend both quantitative and qualitative factors. As such also ESG factors need to be continuously monitored to determine their materiality and their impact on the financial performance, and hence the credit quality of an entity or a financial instrument. Given the interplay of the different ESG factors, fundamental credit factors can limit, offset or amplify ESG risks. ESG factors can be credit positive, neutral or negative. An obstacle for any consistent inclusion of ESG factors in credit analysis is the absence of uniform definitions and standardised data. There is progress on both fronts. ESG standards are becoming a mandatory feature of corporate reporting. In Europe and as part of the EU's Green Deal, e.g. the Corporate Sustainability Reporting Directive becomes applicable to SMEs and will report under the new European Sustainability Reporting Standards (ESRS) developed by the European Financial Reporting Advisory Group - EFRAG. The directive introduces the concept of double materiality: i.e., "how sustainability issues affect their business and about their own impact on people and the environment"[2]. Together with similar initiatives, standardisation will facilitate transparent and comparable identification of the extent of which ESG issues have the potential to become material to the issuer/transaction's credit quality.

1.1 ESG factors and credit rating methodologies

Our rating methodologies explain how ESG factors are integrated in the rating process. As explained below, ESG factors are considered *explicit rating factors* or *implicit rating factors* embedded in other credit rating factors.

ESG factors in credit rating methodologies



Source: Scope Ratings

[1] See Scope's Credit Rating Definitions available here
[2] Source: https://ec.europa.eu/commission/presscorner/detail/en/QANDA_21_1806

Governance and default risk are strongly correlated. Governance considerations have been among the most long-standing and prominent credit rating drivers that are part of all credit rating methodologies. Governance factors indicate how well a corporation is controlled and directed and the extent to which the interests of different stakeholders are safeguarded, including the capacity and willingness of an entity to honour its obligations on time and in full. Thus, governance is crucial and core to our credit assessment in all asset classes. Methodologies describe how governance issues are captured in our credit analysis.

The definition, understanding and relevance of Environmental and Social factors for credit assessments is constantly evolving and tightly linked to the specificities of different asset classes, industries and/or the characteristics of relevant countries and regions. We regularly interact with relevant stakeholders to understand industry best practice or regulatory developments to review and determine the extent of which ESG factors are credit relevant. Our methodologies are transparent in showing how ESG factors are becoming more relevant in credit ratings and the credit impact they can have.

Environmental and social issues are assessed following two different paths:

(1) **as an implicit rating factor** embedded in other rating factors such as the business or the financial risk profiles (applied in Corporates, Covered Bonds, Structured Finance and Project Finance). Rating reports would typically highlight in a dedicated section how ESG considerations influence our views on rating factors.

(2) **as an explicit rating factor**, fully part of the rating construct (applied in Sovereign and Public Sector, Financial Institutions)

1.2 Top-down and bottom-up assessments at sector and issuer levels

The combination of top-down and bottom-up approaches are fully part of the rating process for all our franchises. Sector knowledge and specialisation continue to constitute an essential element in the rating process as it helps to identify and capture risks and opportunities at both sector and issuer/ transaction levels. Specifically:

a) At the sector level, the assessment consists in defining the main driver, issues, risks and opportunities. It is crucial for positioning the issuer/transaction within its sector and compare it to peers. See e.g. the materiality matrices disclosed in Corporates ESG considerations (**section 3**).

b) At the issuer/ transaction level, we investigate how the issuer or the specific transaction addresses sector-specific or business-model specific challenges. An issuer would strive to ensure the sustainability of its operating model. We also review to what extent ESG considerations have an impact on financial performance (gain/loss of revenues, gain/loss of operating margins, capex, litigation costs, etc). Similarly, if the value of collateral provided for an instrument depends on distinctive and tangible ESG factors that have the potential to increase or decrease their secondary market value, ESG factors will be considered in the rating analysis.

ESG risks and opportunities are often not quantifiable nor is it always easy to determine when they will become a driving factor for the credit quality such as biodiversity and social factors. Similarly, the same ESG factor can have a different credit impact depending on the sector, geography, or regulatory environment. The impact may vary from short term to long term. Further, many ESG factors can only be factored in on a qualitative basis. At the same time, the importance of ESG factors can change swiftly, from representing only a remote risk to a more tangible one, even including risk of possible default. Where possible we use quantitative methods and metrics, or provide qualitative guidance on how we incorporate the impact on creditworthiness.

Commitments to reduce carbon emissions and other efforts to address climate change are gaining in credit relevance. Regulatory changes, including changes in pricing mechanisms of greenhouse gas emissions (GHG), are closely monitored as they have the potential to become important rating factors for several asset classes.

Incorporating ESG factors also requires careful application of our methodologies. In the case where a segment-specific methodology has a more nuanced emphasis on ESG risks, it needs to be read in conjunction with its associated general sector methodology.

Consistent application and inclusion of ESG factors in the rating process requires common standards for measurement and disclosure. In absence, we will provide clear disclosure of what information we have used, how we have normalised information to enhance comparability and the assumptions we have made in translating information into an E, S or G credit rating factor.

To help investors, we provide overviews of how ESG factors are typically integrated into our credit analysis (see **section 3**).

1.3 Adherence to the UNPRI

We adhere to the United Nations Principles for Responsible Investments (UNPRI), and integrate environmental, social and governance (ESG) factors into credit analysis. We incorporate the risks arising from an issuer/transaction's exposure to ESG factors as part of the analytical approach reflected in our rating methodologies and regularly update them as our understanding evolves.

2. Credit rating Methodologies

2.1 Sovereign and Public Sector

Sovereign Rating Methodology

Supranational Rating Methodology

Sub-Sovereigns Rating Methodology

Government Related Entities Rating Methodology

UK Social Housing Rating Methodology

2.2 Corporates

General Corporate Rating Methodology

Chemicals Rating Methodology

Construction and Construction Materials Rating Methodology

Consumer Products Rating Methodology

European Utilities Rating Methodology

European Automotive and Commercial Vehicle Manufacturers Rating Methodology

European Automotive Suppliers Rating Methodology

European Business and Consumer Services rating Methodology

Investment Holding Companies Rating Methodology

Oil and Gas Rating Methodology

Metals and Mining Rating Methodology

European Real Estate Rating Methodology

Pharmaceutical Rating Methodology

Retail and Wholesale Rating Methodology

2.3 Financial Institutions

Financial Institutions Rating Methodology

2.4 Covered Bonds

Covered Bond Rating Methodology

2.5 Structured Finance

General Structured Finance Rating Methodology

SME ABS Rating Methodology

CLO Rating Methodology

CRE Loan and CMBS Rating Methodology

Consumer and Auto ABS Rating Methodology

2.6 Project Finance Rating Methodology

General Project Finance Rating Methodology

Aviation Finance Rating Methodology

3. ESG considerations

To illustrate how relevant and sector specific ESG consideration are monitored, assessed and incorporated into the rating analysis, additional guidance is provided by the respective analytical sectors in various formats:

3.1 Sovereign and Public Sector

EU sovereign debt: climate but especially demographics present important long-term risk

EU climate goals: few countries on course to be “Fit for 55”; further reforms needed

Demographics and sovereign credit risk– focus on EU trends

Sovereign ESG risk: direct and indirect environmental risks material for credit outlooks

Africa’s solvency crisis: China’s participation in G20 debt relief a sign of multilateralism, but a “DSSI+” framework is required

ESG and sovereign ratings: Distinct risks, overlap exists, but challenges ahead

Supranational lending: how environmental risks and governance are diverging

3.2 Corporate ratings

ESG considerations for rating construction companies

ESG considerations for rating pharmaceutical companies

ESG considerations for the credit rating of airlines

ESG considerations for credit ratings of consumer goods companies

ESG considerations for the credit rating of retail corporates

ESG considerations for the credit rating of real estate corporates

ESG considerations for the metal and mining industry

ESG considerations for the credit rating of utilities

ESG considerations for chemical company credit ratings

3.3 Financial institutions ratings

ESG in banks Part 1: Assessing environmental factors as a component of bank credit risk

ESG in banks Part 2: Assessing social factors as a component of bank credit risk

ESG in banks Part 3: Assessing governance factors as a component of bank credit risk

ESG and digital transition as measures of long-term sustainability for banks

Climate risk disclosure requirements not without challenges for European banks

3.4 Covered Bond Ratings

Prospects and outlook for ESG covered bonds

Legal framework analysis: Norway

Governance support in Austria's new covered bond framework

3.5 Structured Finance ratings

Integrating climate-change risk into structured finance transactions backed by corporate debt

European CLOs: navigating the ESG landscape

Integrating climate-change risk into structured finance: a stress test-based approach

3.6 Project Finance Ratings

ESG risk considerations in project finance credit risk

ESG Risk considerations in Aviation Finance

4. ESG credit research

The increasing relevance of ESG factors for credit ratings regularly prompts analysts to comment on them in research articles. Scope's ESG related credit research as well as all other research and ratings are available on ScopeRatings and ScopeOne. ScopeOne provides institutional clients access to Scope's growing number of corporate, bank, sovereign and public sector ratings.

5. Other, non-credit rating related ESG Services

As part of its service offerings, Scope Group also offers non-credit related ESG services including:

- Second Party Opinions on an issuer's capability and capacity to meet market standards on Green Bonds, Social Bonds and Sustainability Bonds;
- ESG impact analysis, based on a macroeconomic quantitative model that captures a company's entire supply chain;
- ESG impact indices; as well as
- ESG fund and management ratings;
- Climate stress tests.

More information on these services is available on the website of ESG Analysis available on https://scope-one.com/esg-analysis.

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