

Technical Advice

**ESMA Technical Advice to the European Commission on Sustainability
Considerations in the credit rating market**



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Legislative references, abbreviations and definitions

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|------------------------|---|
| Action Plan | European Commission's Action Plan for Sustainable Finance |
| CRA | Credit Rating Agency |
| CRA Regulation or CRAR | Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit ratings agencies as amended by Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011, Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011, Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013, and Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014 |
| ESG | Environmental, Social, Governance |
| ESMA | European Securities and Markets Authority |

1. Executive Summary

Reasons for publication

1. In its Action Plan for Sustainable Finance, published on 18 March 2018, the European Commission set out two tasks for ESMA in the area of credit ratings (i) to include environmental and sustainability considerations into its Guidelines on Disclosure (ii) to assess the current practice within the credit rating market concerning sustainability considerations.
2. This Technical Advice provides ESMA's input on the second of these tasks. This is done by providing an overview on the level of consideration of ESG factors within a selection of credit ratings.

The reason for this is two-fold:

- i. Credit ratings are assessments of creditworthiness of an issuer or entity, they are not sustainability assessments. It is therefore not possible to assess the practice of sustainability considerations in a market that is not measuring sustainability characteristics;
 - ii. Environmental, Social or Governance factors may be considered as part of a credit rating, however their consideration does not infer that the credit rating can be construed as providing an opinion on the sustainability or otherwise of an issuer or entity.
3. Therefore, while it is not possible to assess sustainability considerations, it is possible to assess the extent to which factors that are classified as either Environmental, Social or Governance factors are considered within CRA's credit assessments. It is this consideration that is the focus of this Technical Advice.

Contents

4. The Technical Advice is structured as follows:
 - Chapter three provides a background to the role of credit ratings in EU legislation;
 - Chapter four provides an overview of the consideration of ESG factors in credit ratings;
 - Chapter five discusses the extent to which the consideration of factors classified as ESG were evidenced within two samples of specific credit rating actions;
 - Chapter six discusses possible regulatory developments and their relevance for some of the concerns highlighted in Chapter 3.

Conclusion

5. The Technical Advice concludes that while it is clear that the CRAs contacted are considering E, S or G factors in their credit ratings, the extent to which each factor is considered varies by asset class, according to the importance assigned to that factor by a CRA's methodology for the purpose of assessing credit worthiness. As a result, while ESG considerations can be a factor, credit ratings should not be understood as providing an opinion on sustainability characteristics of an issuer or entity.
6. In addition, given the specific role credit ratings continue to occupy within the financial system the Technical Advice concludes that it would not be advisable to amend the CRA Regulation to more explicitly mandate the consideration of sustainability characteristics in CRA's credit assessments. Although it could be useful to update the CRA Regulation's disclosure provisions, to provide a more consistent level of transparency around how CRAs are considering ESG factors in these assessments and ensure the CRA regulatory framework keeps pace with ESG developments in other areas.
7. Finally, given the trajectory of EU financial market legislation towards integrating sustainability assessments in the operational and decision-making processes of financial market participants, it may be relevant to assess whether there are sufficient regulatory safeguards in place elsewhere for those non-credit rating products that will fill the need for such sustainability considerations.

2. Introduction

8. On 18 March 2018, the European Commission's published its Action Plan for Sustainable Finance¹. Within this document, Action Point 6 sets out two tasks for ESMA in the area of credit ratings (i) to integrate environmental and social considerations into its Guidelines on Disclosure (ii) to assess the current practice within the credit rating market concerning sustainability considerations.
9. In order to complete these tasks, ESMA staff conducted an informal consultation with CRAs to get a better understanding of current practices in the market. This informal consultation took the form of a voluntary questionnaire to a sample of CRAs and was designed to gather views on the current practices in the market regarding sustainability considerations in credit ratings.
10. Responses to the questionnaire were received during September 2018. ESMA first analysis focused on better understating CRAs' disclosures and identifying areas where CRAs had taken steps to improve the transparency around the disclosure of the consideration of ESG factors in their credit ratings. This formed the basis of the ESG disclosure framework that was proposed in ESMA's Consultation Paper on Disclosures in December 2018².
11. With the initial phase of analysis complete, the focus shifted to assessing the current practices of different CRAs with respect to ESG factors in their credit ratings. The output of this work forms the basis of ESMA's current Technical Advice which is broken down into four main chapters.
12. Chapter three provides an introductory background to credit ratings as defined under the CRA Regulation, an overview of the regulatory safeguards and standards that are in place and the role that they play within EU financial market legislation.
13. Following this, chapter four provides background as to how ESG factors are considered in credit ratings. To do so this chapter condenses the views of CRAs received in response to ESMA's ESG Questionnaire (see Annex I). These views are grouped under the following headings:
 - How are ESG factors being considered by CRAs;
 - How has the consideration of ESG factors changed over the last five years;

¹ [COM \(2018\) 97 Action Plan: Financing Sustainable Growth](#)

² [ESMA 33-9-290 19 December 2018 ESMA Consultation Paper Guidelines on Disclosure Requirements Applicable to Credit Ratings](#)

- What are the challenges behind greater consideration of ESG factors;
- How will the consideration of ESG factors change in the next five years;

14. Chapter five provides an overview of responses received to the questions asked by ESMA in questions two and three of its Questionnaire. These questions focused on asking CRAs how ESG factors were considered in two sets of rating actions, one set of credit rating actions selected by ESMA the other selected by the respondent CRAs.

15. Finally, chapter six of the Technical Advice discusses the relevance of credit ratings in the context of the more systematic integration of sustainability considerations in EU financial market legislation. This section discusses the increased emphasis that is being placed on sustainability considerations under different pieces of EU legislation, and whether it is necessary to consider regulatory safeguards for the products that will be used as inputs for these considerations.

3. Credit Ratings as Assessments of Creditworthiness

16. Credit ratings are defined in EU legislation in Article 3(1)(a) of the CRA Regulation as “*an opinion regarding the creditworthiness of an entity, a debt or financial obligation, debt security, preferred share or other financial instrument, issued using an established and defined ranking system of rating categories*”. This definition establishes that one of the defining characteristics of a credit rating is that it is an assessment of the creditworthiness (of an entity), not an assessment of any other characteristic.

17. Beyond providing a definition as to what a credit rating is and what it measures, the CRA Regulation also sets out operational requirements for CRAs themselves. These include rules to ensure adequate disclosure of information to ensure investors can conduct their own due diligence, rules protecting against conflicts of interest to ensure that credit ratings are not subject to undue influence as well as rules requiring CRA’s to use methodologies that incorporate all factors relevant to the assessment of an entities’ creditworthiness.

18. In order to ensure that these methodologies are independent and free from political interference, Article 23 of the CRA Regulation prohibits, ESMA, the European Commission and any public authority of a member state from interfering in the content of credit ratings or methodologies.

19. The overarching goal of this regulatory framework is to ensure that the credit ratings which are to be used for regulatory purposes within the EU are independent, of a high standard and produced with sufficient safeguards to ensure investor protection and protect financial stability.

20. This is particularly important in light of the critical role that credit ratings still play in determining the capital requirements of EU financial institutions. Where for example those

credit institutions who cannot use the Internal Ratings Based Approach for calculating their capital requirements under CRR, must use the Standardised Approach, which is heavily reliant on credit ratings.

4. Overview of ESG Factors' considerations in Credit Ratings

21. This chapter provides an overview of how CRAs described their consideration of ESG factors in their credit ratings. The basis for the views expressed in this chapter were the responses provided to the Question 1 of ESMA's Questionnaire (see Annex I). While there was some variation between the detail of different CRA's responses, this variation was nevertheless useful as a further layer in understanding the extent to which CRAs are considering ESG factors in their credit ratings.
22. In this regard, the level of detail provided by some respondents demonstrated that while some CRAs are more developed and structured in their approach to the consideration of ESG factors, this distinction is not necessarily dependent on the size or resources of the CRA. This was demonstrated by the level of detail and insight demonstrated by some "smaller" or niche market CRAs that responded to the questionnaire.
23. This chapter addresses the topic under four main headings: (i) how ESG factors are considered in credit ratings; (ii) how has their consideration changed; (iii) what are the challenges involved in their consideration; and, (iv) what are the expected future developments. At the end of each section, a conclusion is provided summarising the key conclusions and views expressed.
24. In addition and with a view to providing supporting context, extracts from specific responses provided by CRAs to the questionnaire are provided within each section in italics.

How are ESG factors being considered by CRAs

25. With regards to how ESG factors are being considered by CRAs in their credit ratings, a common theme among responses was the assertion that Environmental, Social and Governance issues have, at least indirectly, always been a consideration in CRA's credit assessments, given that CRAs are required to incorporate all relevant factors in their credit rating methodologies.

ESG Factors considered on incidental basis

[CRA Respondent 2] "Environmental, social and governance issues have long been considered in our assessment of credit risk, as we seek to incorporate all material credit considerations, including those related to ESG, into our credit rating analysis. We also note that market thinking in this area is evolving. Governance (where material and relevant) is part of CRA 2's consideration of credit risk in applicable sectors and environmental considerations that materially impact an issuer are already embedded in how we consider risk factors in relevant methodologies. Social considerations, however, can be more nebulous; there is no clear definition or universal understanding of the "S" component of ESG. Importantly, our credit rating

analysis focuses only on those Environmental (“E”), Social (“S”) or Governance (“G”) issues that may have material credit implications and does not, therefore, include every such issue that may be of relevance for other purposes.”

26. However, CRAs noted that there is still a degree of inconsistency in how they are able to account for the consideration of each factor. For example, most CRAs highlighted that the relevance of Governance factors to an entity’s credit worthiness, and what constitutes Governance factors was well understood. As a result, it is easier to assess where these factors have been considered and have had an impact on their credit ratings on an ex-post basis. However, this level of understanding is not necessarily replicated for Environmental or Social factors.

Currently there is good understanding of “G” Factors

[CRA Respondent 3] “Environmental and social considerations feature less frequently than governance considerations and more indirectly, generally via factors capturing the prevailing public policy and regulatory environment. Credit ratings in some specific sectors are more directly influenced by environmental considerations (for instance, hydro or wind power projects). In contrast, environmental and social considerations very seldom feature explicitly in the analysis of structured finance securities where the analysis usually focuses on the performance of a portfolio of securitised financial assets, the structure and the legal integrity of a transaction and the credit and operational risk arising from the counterparties of the issuer.

Governance considerations are present in the vast majority of CRA 3’s credit analyses. The quality of corporate governance affects the operational risk of an issuer, of the parties to a securitisation and the parties to an infrastructure project. The effectiveness of governance features in CRA 3’s assessment of the political stability of a sovereign.

27. This is partly a result of there being a less developed understanding as to what exactly constitutes an Environmental or Social factor, and their relevance to the creditworthiness of an entity. A lack of agreed standards for consistent disclosure for this type of information, as well as common definitions as to what activities constitute each factors, were also identified as contributing to problems.

Relevance of “E”, and “S” Factors harder to assess

[CRA Respondent 5] “Financial Institutions

‘G’ factors have traditionally been by far the most important in CRA 5’s rating analysis. For Financial Institutions, these include a host of entity-specific issues relating to the rated entity’s ownership, organisational structure and complexity, risk management and control, and financial disclosure and transparency (see Analytical Pillar 3).

‘G’ factors also feature in our assessment of the operating environment, and this will become more explicit in the updated BRM³, where the regulatory environment and institutional framework is included as a key rating factor, with legal and financial infrastructure as a sub-factor (see Analytical Pillar 1).

‘E’ factors are not integrated into Financial Institutions ratings in any systematic way, although any visible risks could be reflected in our assessment of the bank’s business model and strategy (Analytical Pillar 2) or risk profile (Analytical Pillar 4).

‘S’ factors also do not feature significantly in our methodology. However, while to date we have generally not differentiated between individual Financial Institutions within the same country based on ‘E’ or ‘S’ factors, Financial Institutions ratings could still be affected by changes in ESG factors in cases where such factors impact the operating environment and/or sovereign risk. Indeed, under CRA 5’s ratings architecture, the ratings of most Financial Institutions are capped by the ratings of the home sovereign. Consequently, a change in the sovereign rating due to ESG factors would generally filter through to the ratings of Financial Institutions.

Sovereigns

For sovereign ratings, ‘G’ and ‘S’ factors are considered as part of two key rating factors: (i) Political and Policy Risk; and (ii) Institutional Strength and Administrative Capacity (see highlighted text in the updated SRM).

‘S’ factors also feature in our assessment of Economic Strength (see highlighted text). For example, we may adjust our score for the key rating factor ‘economic growth performance’ for countries where unemployment is stubbornly high. And we may lower our score for ‘GDP per capita’ if income inequality is high or where other indicators of socio-economic development suggest relative living standards are lower than indicated by income per head.

‘E’ factors are captured as a negative adjustment factor when scoring ‘economic growth performance’ and as part of our assessment of ‘long-term risks for exporters of non-renewable resources’ (see highlighted text).”

28. With regards to the differing relevance of E, S or G factors to different categories of rated entity, one respondent provided a useful overview of the relevance of Environmental factors to insurance and reinsurance entities. This respondent discussed how, although not explicitly labelled as such, ESG factors are referred to throughout the building blocks (balance sheet strength, operating performance, business profile etc.) of their credit rating methodology. This echoes what had previously been outlined by CRA 5.

“E” Factors potentially more relevant to insurers

[CRA respondent 4] “Environmental factors, such as climate-related natural catastrophe risks, are considered a severe threat to the balance sheet strength of property and casualty insurers because of their potentially significant, rapid and unexpected impact. The quantitative capital measures of rated companies exposed to natural catastrophes may be subjected to pre-defined stress tests.

³ BRM: Bank Rating Methodology

The business profile assessment also incorporates potential ESG related controversies, which materially and suddenly could damage the company's reputation and brand, impairing its ability to generate new business and retain existing customers.

The impact of country risk is factored into the review of balance sheet strength, operating performance and business profile. CRA 4 defines country risk as the risk that country-specific factors will adversely affect an insurer's ability to meet its financial obligations and separates these factors into three main categories of risk: economic, political and financial system risk. CRA 4's country risk evaluation includes ESG factors such as social stability, the transparency and predictability of the political and legal environments, as well as human development indicators, to score the level of risk in a given country."

Conclusion

29. The views provided by CRAs in response to this section of the questionnaire were relatively consistent. For example, it was frequently highlighted that ESG factors are being considered within their credit assessments, but the level and prevalence depends on the specificities of the underlying methodology. In this regard, it was also highlighted that the consideration of one category of factors may be more common in certain asset classes or industry sectors than others. On the other hand, it has to be noted that it is difficult to form a definitive view as to whether Environmental, Social or Governance factors were considered due to the lack of a consistent set of common definitions. Nevertheless, most respondents recognised the increasing relevance of this information to the users of their ratings and that there is a general need to more systematically account for where they are considered in their credit assessments.

Has the consideration of ESG factors changed over the last five years

30. This section provides an overview of how CRAs have seen the consideration of ESG factors evolve over the last five years. Views of CRAs were mixed. On the one hand a number of CRAs highlighted that they had revised their methodologies in recent years to take ESG considerations in to account. For example, one referred to the inclusion of sustainability accounting in its sovereign methodology. On the other hand, some CRAs outlined that there had been no material changes in their consideration of these factors in this time period.

31. Specifically, one CRA outlined that it does not treat ESG factors as a separate analytical category in rating methodologies or make separate disclosures with regard to such issues. Another CRA stated that while its practices with respect to ESG factors have not materially changed over the past five years, it had noted that environmental factors were becoming more material in its considerations.

For Some CRAs no change in approach to consideration of ESG

[CRA respondent 3] "CRA 3's practices with respect to ESG factors have not materially changed over the past five years though ESG factors, more specifically environmental factors, have become more material

considerations reflecting growing recognition of the long-term adverse effects of climate change on certain sectors and the evolution of environmental policy frameworks.”

32. In terms of concrete actions, another CRA pointed to its signature/adherence of the Principles for Responsible Investment Statement on ESG in Credit ratings⁴ as an indication of its commitment to taking greater account of these factors in its credit rating processes. This same CRA highlighted that since its sovereign methodology was issued, it had worked to enhance how it addresses ESG risks in sovereign ratings. For example, by updating its sovereign methodology to consider sustainability accounting in certain areas.
33. This CRA also outlined that it is working to improve and enhance its communication as to how ESG factors are considered in its sovereign rating actions. An example of this is including an ESG section that summarises where ESG factors were considered in the rating decision process, and to what extent these factors may have contributed to the ultimate rating outcome.

But others have taken steps to further integrate these factors

[CRA respondent 7] “CRA 7’s assessment remains based on five categories of sovereign risk: ‘Domestic economic risk’, ‘Public finance risk’, ‘External economic risk’, ‘Financial stability risk’ and ‘Institutional & political risk’. The respective weights of these key categories in CRA 7’s approach remain unaltered.

However, several revisions had to do with increasing sustainability accounting. Changes included: i) the addition of the old-age dependency ratio under the ‘Domestic Economic Risk’ category of CRA 7’s sovereign quantitative model (CVS), to reflect long-term demographic challenges (increasing the accounting of ‘S’); ii) addition of three more of the World Bank’s Worldwide Governance Indicators (‘G’) in the ‘Institutional & Political Risk’ category of CRA 7’s CVS (political stability, government effectiveness and regulatory quality); and iii) greater deliberation of income inequalities and social considerations (‘S’) in the ‘Macro-economic stability and sustainability’ assessment and of sustainable growth in the ‘Economic policy framework’ of CRA 7’s qualitative assessment (QS). In CRA 7’s view, these updates to CRA 7’s approach – to increase the accounting of long-run demographics, governance standards and sustainable growth – naturally edges the methodology in a longer term direction, further supporting the redressal of short-termism in financial markets.”

34. By way of contrast one CRA outlined that in its view there has been limited change in the extent to which ESG factors have been considered in its credit ratings over the last five years. The reason for this being that in its view it already considers all relevant factors in its credit analysis. As a result, it considers that ESG factors are already being considered where relevant. However, beyond the issue of whether or not they are being considered the CRA has noticed that the impact these factors are having on credit quality have increased in certain asset classes during the latter part of the last five years.

⁴ <https://www.unpri.org/credit-ratings/statement-on-esg-in-credit-risk-and-ratings/77.article>

This includes monitoring the impact of ESG factors over time

[CRA Respondent 1] “In certain asset classes – such as the corporate asset class - there is some evidence that ESG factors and in particular environmental factors may have had a greater impact on credit quality during the latter part of the last five years (specifically, in the 2015-2017 period compared to the 2013-2015 period).”

We have been actively assessing Governance practices since 2000 and have been publishing thematic research on Environmental risk since 2006. The Environmental thematic research that we published back in 2006 and 2007 reflected significant environmental public policy changes in that period, the heightened public policy focus on CO2 emission reductions and the potential credit implication of policy initiatives to reduce emissions.”

35. However, this same CRA points out that it has established a dedicated Sustainable Finance team to coordinate its internal approach to developing new Green assessments and provide training and expertise to its analysts. This move to dedicate greater resources and attention to the relevance of these factors to their credit ratings was also echoed by a number of other CRAs.

Establishing dedicated Sustainable Finance teams

[CRA Respondent 1] “Given the importance of ESG in credit ratings assessments, a key focus for the Sustainable Finance team will be on continuing to enhance transparency, training, and communication around the incorporation of ESG in credit ratings. This will help ensure that [CRA] continues to demonstrate robustness and consistency in our approach to integrating ESG factors into our credit ratings. In this regard, we recently ran cross-practice ESG and credit ratings training for all global analysts.”

We have also added specific ESG expertise in the build-up of the new Methodology Group Centre Of Excellence with a view to continue to clarify the relevance and impact of ESG risks on our analysis and make sure we stay on top of how ESG risks develop.

Issuing dedicated ESG Guidance and Frameworks

[CRA Respondent 2] “We expect to release a cross-sector methodology in the near future that explains our general approach to incorporating each of E, S and G considerations into the determination of credit ratings for all the sectors we rate. In line with all our cross-sector methodologies, the broad principles elucidated in this methodology may be superseded in some instances by more specific guidance contained within sector-specific methodologies. The approach to ESG we describe in the forthcoming cross-sector methodology is not new, but rather presents our consolidated thinking transparently to meet growing market interest in how each of E, S, and G may be relevant to our credit ratings.”

36. By way of balance, two CRAs sought to raise a word of caution to this trend of placing greater focus on the consideration of ESG factors in credit ratings. The first pointed out

that as there is not yet a standardised concept of how ESG factors could be integrated in credit ratings there could be a variation in the consistency how each CRA handles this task. As a result, the net effect could be less rather than greater convergence between how CRAs consider these factors.

But risks of inconsistent integration are possible

[CRA Respondent 7] “Nevertheless, for the time being, CRA 7 does not see a working concept of ESG factors to be integrated into a credit rating product. CRA 7 findings identify high practical analytical complexity to integrate a meaningful ESG rating into a credit rating whose main purpose is to identify an entity’s ability to pay its obligations within the next two to three years. Further, CRA 7 does not see a standardised approach towards the ESG factors across the market which from operational perspective inhibits the implementation of ESG factors into a credit rating.”

37. A second CRA drew attention to the risks that greater integration of ESG factors in credit ratings and greater signposting of whether they were considered could have for investors. In the first of these instances, an overly prescriptive approach mandating ESG consideration could dilute the focus of credit ratings assessment of creditworthiness. With implications for investors who rely on credit ratings for assessing credit risk. On the other hand, drawing too much attention to the extent of ESG consideration could lead to investors misinterpreting credit ratings as providing a view on the sustainability of an entity.

As are risks of misinterpretation

[CRA Respondent 2] “If credit ratings are treated as a proxy for ESG ratings, or are otherwise confused as the primary or only means of communicating ESG information, there is a considerable risk that neither credit ratings nor ESG ratings would serve their intended purpose. Such a conflation might have two consequences:

- Ultimately dilute credit ratings, in turn undermining the quality of information and debate about credit risk in the financial system. Specifically, mandatory inclusion of non-credit relevant factors into credit analysis would risk masking the true credit quality of an issuer or issuance. This will erode the understanding and quality of debate about credit risk in the market and undermine investor confidence.*
- Mislead market users, as credit ratings are not a proxy for ESG assessments. Importantly, it could also thwart the development of a useful gauge for ESG risks that is responsive to the needs of the market.”*

Conclusion

38. Responses on how the consideration of ESG factors has changed, or not, within the CRA market show that while on the one hand, there are a number of CRAs who have been allocating greater resources and time to the consideration of ESG factors in their credit ratings through developing dedicated sustainable finance teams, and some CRAs are

updating their methodologies to better integrate sustainability factors, this is still a developing area of expertise. Some of these CRAs are reluctant or mindful of proceeding further in the absence of clear definitions and standards as to what ESG means in the context of credit ratings. While others rightfully highlight the risks to investors should credit ratings be misinterpreted as measuring characteristics other than creditworthiness.

What are the challenges behind greater consideration of ESG factors

39. With regards to the challenges or obstacles to taking greater account of ESG factors in credit ratings, there was a degree of overlap with the issues highlighted in the previous section. For example, the problem about common definitions was cited by a number of CRAs as an obstacle. However, several other obstacles were highlighted by CRAs which touched on issues such as differences in time horizons, lack of information or disclosure or comparability of the information that was available. These issues are discussed in greater detail below alongside some of the most relevant excerpts from the responses.
40. Concerning differences in time horizons, one CRA highlighted the difficulty in assessing a relationship between Environmental or Social factors with a credit institutions default risk. For example, this CRA highlighted that while it may be possible to arrive at hypothetical conclusions as to the impact of these factors on a credit institutions profile, it was difficult to integrate these hypotheses into their default scenarios on a concrete basis. In addition, this respondent points out that as their ratings look to a 5-10 year horizon, it is difficult to incorporate risks that could impact over a longer time horizon of 20 to 30 years.

Time horizons of ESG factors and credit ratings not always aligned

[CRA Respondent 8] "While many aspects of governance clearly matter when assessing credit risk, environmental and social factors have less immediate relevance to the Financial Institutions rated by CRA 8. Indeed we are unable to recall any episode in recent years where a rating action was taken on an Financial Institutions due to entity-specific 'E' or 'S' factors.

We are not aware of any empirical evidence demonstrating a meaningful causal relationship between 'E' and 'S' factors and the default risk of banks. While it may be possible to construct hypothetical scenarios in which tail risks materialise, we cannot (credibly) rate to scenarios based on long-run supposition.

The rating horizon for Financial Institutions is 5-10 years whereas the environmental risks that could potentially have systemic implications for financial systems, such as climate change, are unlikely to materialise until much later. We have no way of knowing when these risks will materialise (it could be in 15 years or 20 or 30 or 50 or longer), how severe they will be or what impact they will have on the credit strength of FIs (given also that the credit profile of the rated entity as well as its operating environment is likely to have changed significantly over such a long time period).

This lack of visibility, and the fact that credit strength on a 5-10 year horizon is more likely to be driven by other factors, makes it challenging to incorporate long-term environmental risk factors into current rating decisions in a meaningful and credible way."

41. On the same issue, one respondent pointed out that while it is appropriate that CRAs take a long term view of rated entities, the very long term nature of some ESG risks could only be properly incorporated into credit ratings if CRAs were to also lengthen the time horizons of their credit ratings. However, even allowing for this development there would remain difficulties in the comparability of certain ESG factors. One such example being how to measure and compare risks such as political instability or levels of civic participation in the area of sovereign ratings.

This raises a question whether credit rating agencies should take a longer view

[CRA Respondent 7] “The time horizon dilemma remains an ongoing uncertainty – although the time horizon for CRAs is naturally longer-term than that of capital markets (and as such, more able to integrate a range of ESG factors), the very long-term nature of some ESG risks, such as those posed by climate change, begs the question on relative significance to credit ratings, or alternatively whether the horizon of CRAs must be further lengthened. Finally, ESG factors – including the risks of political instability or civil conflict, the openness to civic participation and the costs of pollution, for example – can be hard to explicitly measure on a comparative basis to inform a final assessment on creditworthiness.

While environmental variables (‘E’) may be the least immediately critical of the three ESG pillars to default risk, CRA 7’s Public Finance team believes that environmental risks may become increasingly important in the future as both the global ecological environment and market internalisation of environmental risks evolve, recognising future global risks, like those posed by climate change. Other areas of overlap worth exploring range from influences of ESG on potential growth to the impact on long-run fiscal costs to impacts on financing rates and financing availability (recognising the inception of ESG investment benchmarks).”

42. This issue of a lack of comparability in underlying ESG information was also highlighted by another CRA. This CRA pointed out that as most credit ratings are a measure of relative credit risk, any quantitative indicators supporting this process should only be done on the basis of standardised inputs that could be measured and compared.

However a lack of comparable information would still be a problem

[CRA Respondent 8] “We also lack the quantitative tools for such long-term analysis and at best would only be able to make a qualitative and highly subjective assessment of long-term risks. We note that some commentators have called for more use of scenario analysis in this context, but in our opinion long-term quantitative based assessment are challenging to conduct, while the number of assumptions required (including about policy paths and technological developments) undermine their plausibility and usefulness in determining current ratings.

An additional challenge on the data side concerns the construction of appropriate metrics/indicators for assessing a large number of ESG factors. Given that most types of credit ratings are meant to measure relative credit risk on an internationally comparable basis, significant work still needs to be done to develop standardised metrics that can be used for peer group analysis.”

43. This issue was discussed on a more practical basis by another CRA which highlighted the unevenness of reliable information between the categories of E, S and G. For example,

disclosure of information relating to Governance factors was already well embedded in most developed countries. However, even in these cases information and disclosures around Environmental or Social factors was not universal. As elsewhere, this respondent pointed out the lack of common standards and definitions as an obstacle to this improved disclosure.

As would the variation in availability of E, S and G disclosures

[CRA Respondent 2] “One of the challenges in developing ESG ratings or assessments is the lack of consistent disclosure of some of the elements of E, S, and G. For example, there is typically a good standard of disclosure with respect to governance issues across most developed economies. By contrast, disclosures with respect to compliance with societal or environmental principles – such as an issuer’s willingness to take E or S factors into account in its strategy – are less consistent.

More generally, we refer to our observations above relating to a lack of consistent definition and understanding in the market around ESG issues, in addition to a lack of common reporting standards and the absence of a compelling information database.”

44. As a related issue, another CRA highlighted that even if reliable information was available on Environmental factors, this may not be sufficient to provide a useful input on the future rate of occurrence of environmental events, should their likelihood of occurrence increase beyond the historical observations.

Predicting future likelihood Environmental risks challenging

[CRA Respondent 1] “Climate risk may not be as difficult to analyse ex post (i.e. after a climate related weather event or as a general trend) however it is difficult to predict ex ante (i.e. whether climate change will cause a weather event to happen and when the event could happen). Many experts argue that climate change will increase the incidence and severity of weather events such as hurricanes and droughts but also recognize that it is difficult to attribute any given weather related event to climate change alone.

It is widely believed that climate change makes extreme weather events significantly more likely to occur but they are not impossible without it. As relevant variables evolve, such as the rate of climate change, the impact of climate change and the public policy stance as regards climate change, this could potentially generate more Environmental risks that are germane to our credit ratings analyses.

Conclusion

45. Responses of CRAs to this section of the questionnaire were interesting, given the recurring nature of the problems highlighted. These problems included difficulties in collecting reliable and comparable information for Environmental and Social factors which could be used to create standardised metrics for assessing different entities or issuers. In addition, there were related problems regarding how, even where information on Environmental factors was available, this ex-post data may not be useful for predicting the likelihood of events on an ex-ante basis.

46. On the positive side, respondents noted the relatively well-developed disclosure of Governance information for sovereigns in developed economies. This suggests that if the quality and quantity of disclosures relating to Environmental and Social factors could be developed along similar lines through improved non-financial disclosures, this issue might be addressed. In any event, even allowing for a greater quantity and higher quality of information, there would still be an issue with the disconnect in the time horizons between the maturity of rated instruments and the crystallisation of any E, S or G risks. To address this last issue, there did not appear to be a clear consensus among respondents although possible approaches are addressed in greater detail in the following section.

How will the consideration of ESG factors change over the next five years

47. Considering some of the challenges highlighted in the previous section, the question arises as to how CRAs see the consideration of ESG factors in credit ratings evolving over the next five years. What was interesting about views expressed in this section was the importance that CRAs gave to two potential drivers, one being market demand and the other being public policy decisions. These two aspects would appear to be central to the extent which credit ratings will adapt to incorporate ESG considerations over the coming years.

48. In relation to the market driven demand, one respondent highlighted the possibility of a virtuous circle of behaviour forming, where the increasing importance of ESG factors to stakeholders such as investors and regulators leads to rated entities placing a greater emphasis on considering these factors in their activities. This in turn makes it easier for the rated entities to disclose relevant ESG information, which helps CRAs integrate it further in their credit ratings.

Greater market acceptance could lead to more widespread integration

[CRA Respondent 4] "Going forward, CRA 4 expects that, as rated entities embrace ESG practices more widely, and pressure from stakeholders increase, ESG related risks and opportunities may become more material as part of the credit rating process. CRA 4 continues to evaluate issues which impact the insurance industry, which will increasingly include ESG issues as their materiality becomes more evident, through tailored discussions with rated entities, risk-modellers, consultants and industry associations."

49. This market led development is shared by another CRA highlighting that the growing demand for a consideration of these factors by stakeholders will require CRAs to make efforts to ensure their consideration is more systemically integrated into their methodologies, regardless of whether they have an impact on the eventual ratings.

More widespread integration could lead to more systemic consideration

[CRA Respondent 8] "We are cognisant of the fact that interest in ESG factors is increasing in a number of our core markets (some of which are well behind the EU in this regard) and that the impact of 'E' factors, in

particular climate change, is becoming more visible in many parts of the world, with some industries/sectors (generally outside of CRA 8's ratings universe) increasingly affected from a medium-term credit perspective.

Although we think it unlikely that 'E' factors will emerge as key rating drivers for the Financial Institutions we rate in the coming years, we nevertheless intend to increase our monitoring of such risks and in particular to consider their credit relevance as part of periodic criteria reviews (starting in 2019) with a view to the greater incorporation of such risk factors (as well as risk mitigation and elimination strategies) in our rating methodologies and guidelines for preparing rating reports.

The aim over the next one-to-two years is to introduce a more systemic approach to considering ESG factors. This will include ensuring that rating analysts are aware of such risks and that rating committees consider such risks during meetings. Rating committees may conclude that such risks are not material and therefore do not need to feature to any extent in rating reports, but this would be after explicit consideration."

50. On the other side, it is also recognised that public policy might be also have a material impact on the consideration of ESG factors in credit ratings either by imposing requirements on rated entities which make ESG considerations more material to their credit profiles, or by legislating to improve the quality of ESG related disclosures.

Public Policy as a driver of greater integration of ESG

[CRA Respondent 1] "Whether ESG credit factors have a more or less prominent impact on creditworthiness over the next five years will depend on whether there are perceived changes in the materiality and relevance of ESG credit factors. That in turn will depend on variables including how ESG-related public policies change, how social behaviour might evolve, how entity behaviour could evolve and how entity disclosure standards will evolve (disclosure standards will impact the level, quality and consistency of publicly available ESG-related information).

Credit rating actions may be based on future policy actions against climate change or other environmental, social, or governance trends - as regards factors such as regulation, subsidies, carbon pricing and other government interventions - that impose new costs or create opportunities for rated entities. A credit rating can reflect our view of the potential effects of a given policy action once we believe that policy is highly likely (for example, if a related law or regulatory requirement has been, or is close to being, adopted). This makes its potential credit implications more predictable. In some cases, we would also consider the potential credit implications, and possibly take rating actions, where a policy's implementation date lags when it was agreed and put in place."

51. In addition to the possibility that credit ratings may, through market driven or public policy events, more systematically consider ESG factors, at least one CRA is already developing or foresees the need to develop stand-alone products that will specifically measure and assess the ESG characteristics of rated entities. By taking this approach, CRAs feel that it will enable them to satisfy the demand for ESG focused assessments from market participants, while at the same time ensuring that their credit assessments remain focused on pure credit assessments of an issue or issuer.

Potential for stand-alone ESG products to meet demand

[CRA Respondent 7] “CRA 7 is currently studying two main potential alternatives for assessing ESG norms, via either an ESG built-in system of metrics or an add-on report within our credit analysis.

A) Built-in report

This format for the report would include ESG norms within our current Industry and Business risk profiles and modify accordingly our analysis of the credit quality of the rated corporate. While the integration would lead to a single sustainability-adjusted rating,

B) Add-on model

The solution CRA 7 is considering is the creation of a complementary report, aimed at assessing the respect of ESG norms of the rated entity on a separate basis from the credit rating. A company could therefore be assessed with a numerical rating from 1 to 5, 5 being the highest level of ESG compliance, 3 being ESG neutral and 1 being the worst level of ESG compliance. This complementary report would have the advantage of not colliding with our rated entities as the two reports would have different aims.”

52. Finally, one respondent highlighted the risks posed by credit ratings being interpreted as something other than a proxy for the creditworthiness of an issue or issuer. This respondent highlighted that what is needed is a clear delineation between the two types of assessments, with clearly agreed standards and definitions for ESG assessments, to match those already in place for credit ratings.

Conclusion

53. Whether developments in relation to the consideration of ESG factors by credit rating agencies are market driven, or public policy driven, CRAs would appear to be aware that this is an issue of growing importance to which they will need to devote greater resources over the coming years. To some extent, the pace and consistency of these efforts will depend on external factors such as whether standardised terms and definitions for ESG factors will be introduced by policy makers, for example with proposals on disclosures relating to sustainability⁵, or a framework to facilitate sustainable investment⁶. At this point, it is therefore difficult to gauge in concrete terms the direction of CRAs’ consideration of ESG factors in credit ratings, however, there does appear to be a move towards providing sustainability assessments outside of the credit rating space, through new product offerings. It is this area that could see the most rapid developments over the coming years.

⁵ Proposal for a Regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341

⁶ Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment

5. Consideration of ESG Factors in Specific Rating Actions

Introduction: methodological approach

54. This chapter of Technical Advice focuses on assessing the responses provided by CRAs to Questions 2 and 3 of ESMA's questionnaire on the consideration of ESG factors in individual credit rating actions (see Annex I), specifically:

- Whether and how ESG factors were considered within specific ratings actions selected by ESMA⁷ (ESMA's sample).
- Whether and how ESG factors were considered within specific rating actions selected by the CRA⁸ (CRA's sample).

55. In terms of the total number of responses, 11 CRAs were contacted by ESMA via questionnaire, of these 11 CRAs responses were received from nine, of these nine responses, eight provided answers to questions two and three of the questionnaire⁹.

56. The total number of rating actions assessed from these 8 responses under both ESMA's sample and CRA's sample is 57. These 57 rating actions can be broken down into the following categories of credit ratings: 17 Non-Financial Corporates, 11 Financial Corporates, 7 Insurance, 13 Sovereign and 9 Structured Finance ratings. These categories were based upon the classification system for reporting credit ratings and rating outlooks to ESMA's CEREP database¹⁰, on the basis that it would ease the process of comparability for ESMA and provides a common language of classification for the CRAs' responses to questions two and three.

57. To the extent possible, ESMA's sample requested rating actions on entities who had a rating from another CRA to whom the questionnaire was addressed and for which a rating action was available within the last two years. The rationale for this was to ensure that credit ratings assessed were (a) comparable and (b) a reflection of that CRAs current or recent practice in considering ESG factors.

⁷ In selecting these credit rating actions ESMA selected like for like issuers across CRAs in order to assess whether there were different approaches to the assessment of ESG factors within the same issuer type by CRA. Ratings were selected by RADAR category in the following ratio 2 Non-Financial Corporates, 1 Financial, 1 Insurance, 1 Sovereign, 1 Structured Finance. For smaller CRAs with less coverage this number was reduced.

⁸ CRAs were requested to provide an equal number of their own credit rating actions within the same asset categories as those selected by ESMA. The purpose of this was to receive a balanced overview of practices within the industry.

⁹ One CRA who did provide a response provided it in a manner that was difficult to analyse in the time frame for producing this report, the rating actions from this sample are therefore not included.

¹⁰ Article 3 "Rating Types" and Article 4 "Corporate Ratings" of Commission Delegated Regulation (EU) 2015/2 of 30 September 2014 supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council with regard to regulatory technical standards for the presentation of the information that credit rating agencies make available to the European Securities and Markets Authority.

58. Within these overarching criteria ESMA selected credit ratings on the following basis; for non-financial corporates ESMA requested credit ratings for two industrial corporates; for financial corporates ESMA requested credit ratings for one multi-national banking institution; for insurance entities ESMA requested credit ratings for one multi-national insurance or reinsurance undertakings; for sovereign ratings ESMA requested credit ratings for one EU sovereign.
59. Within the questionnaire for each rating action (ESMA's or CRA's sample), CRAs were requested to indicate the quantitative and qualitative ESG factors used in determining the rating action. In replying to this question, some CRAs adopted a narrow interpretation, highlighting where the consideration of ESG factors only where they were a key driver behind the change of the credit rating, whereas others CRAs adopted a broader interpretation, highlighting where the consideration of ESG factors were considered as part of the whole range of factors in determining the rating, even where they were not necessarily a key driver of a the change in the credit rating. Given the purpose of the questionnaire was to gain a better understanding of how ESG factors are considered in credit ratings on a general basis and not just where they are driving changes in credit ratings, ESMA has adopted the broader interpretation for the purposes of its assessment.
60. On this basis, ESMA has assessed that out of the total of 57 rating actions, factors categorised by the relevant CRA as either E, S or G were considered in 38 rating actions. Of these factors, G factors were the most frequently occurring although their prevalence, along with the other two categories of factors varied according to the specific rating category. Further analysis on the prevalence of the consideration of the different factors in different rating categories is provided in the following sub-sections. In this regard, despite differences in how CRAs responded to the questions in the questionnaire, some commonalities in the results are evidenced. Nevertheless, the conclusions of this chapter should not be understood as a definitive assessment of the practices of all CRAs operating in the EU. In addition, this chapter does not take a view as to whether greater or lesser consideration of ESG factors should have been taken within the credit rating actions that were assessed.
61. With a view to providing additional context on the basis of how ESG factors are considered within each rating category, an excerpt from a CRA's response explaining how that CRA considers ESG factors in that asset class is also provided alongside the rating actions.

Non-Financial Corporates

62. The non-financial corporate rating category encompasses corporate credit ratings excluding financial institutions (banks, brokers and dealers) and insurance undertakings. The entities in this sample were typically assessed according to CRAs Corporates Methodology, but in some cases were also assessed according to sector specific methodologies such as "Steel Industry" or "Global Chemical Industry".

ESG Factors in Corporate Rating Methodologies

As part of its questionnaire ESMA requested CRAs to outline how the consideration of ESG factors is demonstrated within their credit rating methodologies. The following is one such example:

"[CRA] has developed Corporate Governance criteria and a related checklist that is completed for each rating as part its annual review. The criteria outline [CRA] approach for assessing corporate governance while the checklist allows the analyst to note any material governance deficiencies that may raise a credit concern.

In general, other ESG factors are not listed explicitly among the primary factors in the methodologies which [CRA] uses to determine the rating but their impact is considered within other broader primary Business Risk Assessment (BRA) factors. For example:

- In Rating Companies in the Mining Industry, the BRA factor for Political Risk describes that margins can be impacted by "expensive environmental regulations" among other factors.*
- In Rating Project Finance, Rating Wind Projects, and Rating Solar Projects, the Revenue Stability/Offtake Agreement factor is partly determined by the renewable resource projections. [CRA] considers the impact of climate change on altering the forecast of the renewable resource, and by extension, the projected revenues.*

In other methodologies, ESG factors may be listed as, or incorporated into, Additional Business Risk Assessment (Additional BRA) factors, which analysts can elect to use for certain issuers on a case-by case basis. For example:

- In Rating Companies in the Oil and Gas and Oilfield Services Industries, the potential impact of carbon pricing on issuers are explicitly covered in an Additional BRA entitled "Regulation/Environmental Factors".*
- In Rating Companies in the Forest Products Industry, the potential impact of environmental concerns on fibre supply and prices is captured through an Additional BRA factor called "Regulation".*
- In Rating Companies in the Pipeline and Diversified Energy Industry, an Additional BRA entitled "Environmental Factors" focuses on the impact of environmental concerns on prevailing regulation and business prospects.*
- In Rating Companies in the Independent Power Producer Industry, environmental considerations are captured through the Additional BRA factor called "Environmental Exposure", although certain aspects of environmental considerations are also captured in two primary BRA factors, namely "Market Structure and Diversification".*

63. From the nine overall respondents, a total 17 Non-Financial Corporate rating actions were assessed from 5 CRAs. In these 17 cases, there were eight in which CRAs highlighted that E, S or G factors were considered as part of the credit rating or were a driver behind the change in the credit rating. One CRA chose not to provide an equal number of examples as requested by ESMA. Unlike the other rating categories, ESMA requested CRAs to

provide two rating actions in the ESMA sample, while providing two more in their own sample. The outcome of the assessment is outlined in Table 1.

TABLE 1 NON-FINANCIAL CORPORATES

| Combined Sample | Non-Fin Corporate rating 1 | | | Non-Fin Corporate rating 2 | | |
|-----------------|----------------------------|----|-----|----------------------------|-----|-----|
| | E | S | G | E | S | G |
| CRA 1 ESMA | No | No | No | No | No | No |
| CRA 1 Own | Yes | No | No | Yes | No | No |
| CRA 2 ESMA | Yes | No | No | No | No | No |
| CRA 2 Own | Yes | No | No | No | Yes | No |
| CRA 6 ESMA | No | No | Yes | Yes | Yes | Yes |
| CRA 6 Own | Yes | No | Yes | N/A | N/A | N/A |
| CRA 7 ESMA | No | No | No | No | No | No |
| CRA 7 Own | No | No | No | No | No | No |
| CRA 9 ESMA | No | No | No | No | No | Yes |

64. From the above, it can be seen there was a clear prevalence for Environmental factors being considered in the sample of ratings requested by ESMA. This would appear to run contrary to the responses from CRAs to Question 1 of the questionnaire that either Environmental factors are less frequently considered, or at least harder to assess as relevant to a corporate issuer’s creditworthiness. However, it is more likely a direct result of the entities selected in the ESMA sample being the same chemical and steel manufacturer. For these two entities, given that corporates in this sector are involved in potentially more environmentally impactful activities, it is less surprising that environmental factors are more embedded in the underlying sectoral methodology given their potential relevance to creditworthiness.

Financial Corporate

65. The Financial Corporate rating category encompasses corporate credit ratings including financial institutions, including banks, brokers and dealers but excluding insurance undertakings. The entities in this sample were typically assessed according to CRAs “Banks” or “Global Banking” Methodologies.

ESG Factors in Financial Corporate Methodologies

As part of its questionnaire ESMA requested CRAs to outline how the consideration of ESG factors is demonstrated within their credit rating methodologies. The following is one such example:

“Our analysis of ESG risks and strengths can be undertaken through different elements of our bank rating methodology. The starting point for assigning a credit rating to a bank in a given country is the anchor we derive by applying our Banking Industry Credit Risk Assessment methodology. This macro analysis of the industry and economic risks in a given market could, for instance, be affected by identified deficiencies in the overall quality of a banking system’s governance and transparency, or material system-wide effects related to climate change.

Business, capital, and risk profiles: To derive a credit rating on a specific bank, we then modify the anchor by incorporating our assessments of factors including its business, capital, and risk profiles. In assessing the business position, we analyse a bank’s revenue stability, the diversification of its revenue stream, and the quality of its management and strategy. If a bank’s business activities are concentrated in an area or sector we consider could be adversely affected by climate change, this could weaken its business position and put its rating under pressure. Even if a bank reduces its exposure to climate sensitive industries, the pressure on its business position may not ease until it finds an adequate replacement for the lost revenue. That said, if a bank develops expertise and becomes an industry leader in a climate change-related niche, it could reinforce its business profile, to some extent, by strengthening revenue stability and increasing market share.

Governance: As part of our analysis of a bank’s business position, we also form a view of its governance, which is an important component of our assessment of the quality of management and strategy. For example, in Russia and the Commonwealth of Independent States, we have recently observed that in several cases management and governance shortfalls have contributed to bank failures. These weaknesses include opaque ownership, business models that rely too heavily on new business at unsustainable margins, unstable management teams, inflated capital values, and extensive engagement in related-party lending. The risk of ineffective governance is not region-specific or inherent to countries that have a weak institutional framework. For instance, some financial institutions in developed economies, including those in Western Europe and the U.S., have uncovered large-scale governance failures, frequently arising from the interaction of poor incentive structures and limits on managerial oversight over large and complex financial institutions.

Risk position: Although our capital assessment looks at expected credit- and market-risk elements of a bank’s activities, our assessment of a bank’s risk position incorporates risks that are not captured directly in our capital model. Therefore, we consider ESG factors in our assessment of risk position. For example, our credit ratings could be affected if we anticipate that a bank will suffer losses due to the impact of climate change on its loan and investment portfolios. This could include losses from climate risk-related exposures that emerge on assets that act as collateral for loans. The risk position assessment may also weaken if, in our view, the bank is exposed to significant legal risks. Costly litigation arising from weaknesses in governance has, in many recent cases, given rise to new risks not related to the credit quality of loans and investments, even for traditional banking activities. Alternatively, expected losses can also weigh on our projected earnings for a bank, and thus on our capital and earnings assessment. Potential losses could, for example, be linked to the upcoming settlement of pending litigation, losses on investments, or an expectation that reserves could rise significantly due to climate change exposure in the underlying loans.”

66. From the nine respondents, a total 11 Financial Corporate rating actions were assessed from 6 CRAs. In these 11 cases, six actions were assessed as either being driven by or

having considered ESG factors. However, even allowing for the broader interpretation as to whether ESG factors were considered in these credit rating actions, a common theme is clearly visible, namely that the consideration of Governance factors is far more prevalent in this area than the other two categories of E and S (see figure 2 below). This is to a large degree representative of the responses provided by CRAs to Question 1 of ESMA questionnaire where CRAs identified difficulties in assessing the impact of Environmental and Social factors on the creditworthiness of financial institutions (see paragraph 26).

TABLE 2 FINANCIAL CORPORATES

| Combined Sample | Financial Corp | | |
|-----------------|----------------|--------|------------|
| | Environmental | Social | Governance |
| CRA 1 ESMA | No | No | No |
| CRA 1 Own | No | No | Yes |
| CRA 2 ESMA | No | No | No |
| CRA 2 Own | No | No | Yes |
| CRA 3 ESMA | No | No | Yes |
| CRA 3 Own | No | No | Yes |
| CRA 5 ESMA | No | No | No |
| CRA 5 Own | No | No | Yes |
| CRA 7 ESMA | No | No | No |
| CRA 7 Own | No | No | Yes |
| CRA 9 ESMA | No | No | No |

Structured Finance Instruments

67. The Structured Finance category refers to ratings that relate to a financial instrument or other asset resulting from a securitisation transaction or scheme referred to in Article 4(1)(61) of Regulation (EU) No 575/2013. The instruments assessed in this category were typically assessed according to specialised structured finance rating methodologies specific to the type of structured finance instrument.

ESG Factors in Structured Finance Ratings

As part of its questionnaire ESMA requested CRAs to outline how the consideration of ESG factors is demonstrated within their credit rating methodologies. The following is one such example:

Example 1

"In European CMBS¹¹ Rating and Surveillance Methodology, environmental contamination may affect CRA 3's valuation of properties backing the rated debt. CRA 3 states that it "generally reviews all third-party due diligence reports prepared for the loan originator as part of its loan origination process. These reports

¹¹ CMBS: Commercial Mortgage Backed Securities

typically include environmental and technical reports which are used to identify any possible significant contingencies, such as environmental contamination, structural faults or deferred maintenance. If a Phase II environmental report is recommended, CRA 3 reviews the results. CRA 3 may increase the property capitalisation rate applied or make other adjustments if contamination is present and not appropriately mitigated.”

Example 2

“Structured finance vehicles typically hold a pool of financial assets such as loans, bonds, leases, or receivables that generate cash flow over time. Our analytics focus on the following factors: the credit quality of the securitized assets; legal and regulatory risks; payment structure and cash flow mechanics; operational and administrative risks; and counterparty risks. For example, as part of the operation and administrative risks, we review key transaction parties, such as the party that acts as the ongoing servicer of the asset pool. Though ESG is typically not a factor specifically considered in our SF¹² analytics, SF use [CRA]s corporate, bank and insurance credit ratings as inputs in the derivation of SF credit ratings and so Environmental, Social and Governance factors may have an indirect impact if those factors are deemed to be material to the credit ratings.

For example, the possible effects of ESG risks include:

- The credit rating on a key transaction party, such as the servicer of the pool is lower;*
- The credit rating on a counterparty is lower; or*
- The credit ratings on specific corporate obligors in a collateralized loan obligation pool are lower.*

We would consider the impact of this information in our analytics when reviewing the specific transactions, although it may not ultimately affect the credit ratings on the structured finance transaction.”

68. From the nine respondents, a total nine Structured Finance rating actions were assessed from five CRAs. In these nine cases, five actions were assessed as either being driven by or having considered E, S or G factors. This is perhaps contrary to what would be expected of issuers or entities lacking a traditional corporate structure. However, given the explanations provided by CRAs that their Structured Finance methodologies can draw upon corporate, financial and sovereign ratings where they are relevant to the underlying exposures this is understandable. As a result, a structure finance instrument can find itself exposed to E, S or G considerations on an indirect basis.

¹² SF: Structured Finance

TABLE 3 STRUCTURED FINANCE

| Combined Sample | Structured Finance | | |
|-----------------|--------------------|--------|------------|
| | Environmental | Social | Governance |
| CRA 1 ESMA | No | No | No |
| CRA 1 Own | Yes | Yes | No |
| CRA 2 ESMA | No | No | No |
| CRA 2 Own | Yes | Yes | No |
| CRA 3 ESMA | No | No | No |
| CRA 3 Own | Yes | No | No |
| CRA 7 ESMA | No | No | Yes |
| CRA 7 Own | No | No | Yes |
| CRA 9 ESMA | No | No | No |

69. However, given that one of the defining characteristics of these instruments is that payments in the transaction or scheme are dependent upon the performance of the underlying exposure or pool of exposures and that these exposures may cut across different economic sectors or geographical boundaries, it is reasonable to expect that they are indirectly affected by the E,S or G factors impacting these sectors. For example, an instrument which is composed of a loan pool of Italian residential mortgages may have exposure to the macro economic climate of Italy, as well as the stability of the Italian banking sector. This even spread of the consideration of ESG factors, which is to some degree absent in the other rating categories is therefore more understandable.

Insurance

70. The insurance category are ratings classified as corporate but that are not financial institutions, banks or brokers and dealers. The entities in this sample were typically assessed according to CRA’s insurance and reinsurance methodologies, which are different to those used for banking institutions.

ESG Factors in ratings for Insurance and Re-Insurance Undertakings

Components of ESG are referred to (albeit not explicitly named as such) throughout the building blocks (namely balance sheet strength, operating performance, business profile and Enterprise Risk Management (ERM)) described in [methodology], based on their materiality to the credit rating analysis. One issue in identifying “ESG” as a unique rating component, as opposed to describing individual factors within ESG, is a lack of uniformity in the definition of ESG. Listed below is [CRA]s interpretation of the relevant elements of ESG which are factored into our insurance ratings analysis.

Environmental factors, such as climate-related natural catastrophe risks, are considered a severe threat to the balance sheet strength of property and casualty insurers because of their potentially significant, rapid and unexpected impact. The quantitative capital measures of rated companies exposed to natural catastrophes may be subjected to pre-defined stress tests. [CRA] expects insurers accepting catastrophe

risk to be able to demonstrate that they can effectively manage catastrophe risk and have the financial wherewithal to absorb potential losses. Climate change has the potential to lead to an increase in the severity and frequency of severe natural catastrophe events.

Environmental factors are also included within the ERM¹³ assessment, which considers the quality of an insurer's catastrophe stress testing program. What-if scenario testing using severe events in areas with concentrated exposures is crucial to understanding maximum potential loss and managing catastrophe risk. Companies also need to consider potential un-modelled scenarios in addition to model output to ensure that they are not overexposed to unforeseen events.

Asset risk is another key component of the balance sheet strength assessment. [CRA] is well aware that some insurers have begun integrating ESG factors into their investment process. However, the credit analysis focuses on risk, performance and the consequences from changes in investment strategies – including, but not exclusively, those based on ESG considerations.

The business profile assessment also incorporates potential ESG related controversies, which materially and suddenly could damage the company's reputation and brand, impairing its ability to generate new business and retain existing customers.

The impact of country risk is factored into the review of balance sheet strength, operating performance and business profile. [CRA] defines country risk as the risk that country-specific factors will adversely affect an insurer's ability to meet its financial obligations and separates these factors into three main categories of risk: economic, political and financial system risk. [CRA]'s country risk evaluation includes ESG factors such as social stability, the transparency and predictability of the political and legal environments, as well as human development indicators, to score the level of risk in a given country.

Governance factors are considered explicitly under the ERM building block. In the update to the [methodology] ERM was specifically included as a building block within the ratings criteria. While ERM has been part of the analysis for a number of years, the explicit assessment of ERM was added for enhanced transparency. During the last few years, much work has already been done in respect of the ERM assessment building block, with a focus on governance, risk culture, embedding of best practices and consideration for emerging and non-modelled risks. [CRA]'s evaluation of an insurer's ERM takes a holistic view of its risk management system and associated strategies, processes, tools and owners.

71. Given that not all CRAs provide ratings for insurance undertakings, the pool of ratings assessed in this category was smaller than in other categories. From the nine respondents, a total of seven insurance rating actions were assessed from four different CRAs. Of these, seven rating actions were assessed as either being driven by or having considered one of E, S or G factors.

¹³ Enterprise Risk Management

TABLE 4 INSURANCE

| Combined Sample | Insurance | | |
|-------------------|---------------|--------|------------|
| | Environmental | Social | Governance |
| CRA 1 ESMA Sample | Yes | No | Yes |
| CRA 1 Own Sample | No | No | Yes |
| CRA 2 ESMA Sample | Yes | No | No |
| CRA 2 Own Sample | Yes | No | No |
| CRA 4 ESMA Sample | Yes | Yes | Yes |
| CRA 4 Own Sample | Yes | Yes | Yes |
| CRA 9 ESMA Sample | Yes | No | Yes |

72. What was noted in these rating actions was the greater prevalence of Environmental and Governance factors relative to other rating categories. This prevalence, in particular of Environmental factors, is broadly in line with the responses provided by CRAs in response to Question 1 to ESMA Questionnaire where it was highlighted that the relevance of natural catastrophes to insurers business models is more embedded in the underlying methodologies than in other areas given the relatively clear relationship that can be drawn between the occurrence of these events and the creditworthiness of these entities (See paragraph 26).

Sovereign and Public Finance Ratings

73. The sovereign and public finance category includes both sovereign and sub-sovereign issuers. However, for the purposes of this report, the rating actions provided by CRAs were limited to sovereign ratings. The entities assessed in this sample were therefore all produced according to CRAs' sovereign methodologies.

ESG Factors in ratings for Sovereign and Sub-Sovereign Ratings

Sovereigns

[CRA]s sovereign methodology directly embeds a partial set of ESG factors, especially accounting for social and governance factors: Variables related to governance ('G') have been found to be effective indicators of sovereign credit risk. Therefore, governance is included in the framework as the fifth independent pillar of [CRA]s sovereign methodology: 'Institutional & Political Risk', with a 10% weight overall. This includes considerations of the rule of law, control of corruption and voice & accountability under the quantitative evaluation, predicated on the World Bank's Worldwide Governance Indicators. In addition, analyst assessments include those of governance standards and the nation's policy direction, as well as geopolitical and event-related risks – such as those from war and civil unrest.

Within the 'Domestic Economic Risk' dimension of the methodology (a 35% weight), factors related to 'S' are captured explicitly in [CRA]s quantitative model via the GDP per capita, unemployment rate, real GDP growth and old-age dependency ratio variables. The inclusion of GDP per capita, for instance, also embeds indirect accounting of other 'S' factors, like human capital and education, poverty, well-being, and health,

which an economy's income level is highly correlated with. In addition, in [CRA]'s Qualitative Scorecard (QS), an economy's capacity for sustainable growth, demographic risks, income inequalities and social considerations are considered in the 'Macro-economic stability and sustainability', 'Economic policy framework', and 'Growth potential of the economy' analyst evaluations. The role of old age costs and health care cost sustainability are also deliberated in the 'Debt sustainability' assessment in the QS.

The assurance of sustainable economic growth and involvement of environment factors in sustainable growth are currently accounted for in [CRA]'s Qualitative Scorecard in the 'Economic policy framework' and 'Growth potential of the economy' assessments on a sovereign, although the weighting of environment in these evaluations is not high. The impact of environmental factors on fiscal performance (such as via environmental and carbon taxes) may be captured in the primary balance, a component of the quantitative model (CVS). The increasing importance of strengths of a sovereign issuer on environment in ensuring access to new green bond and other sustainability-linked financing channels is considered in the 'Market access and funding sources' assessment under the QS. The risk of natural disasters (and imposition of costs on economic growth and fiscal performance), including those resulting from climate change, is accounted for in [CRA]'s 'Extraordinary circumstances' rating adjustment, available to be used at the rating committee level.

TABLE 5 SOVEREIGN AND PUBLIC FINANCE

| Combined Sample | Public Finance | | |
|-----------------|----------------|--------|------------|
| | Environmental | Social | Governance |
| CRA 1 ESMA | No | Yes | Yes |
| CRA 1 Own | No | Yes | Yes |
| CRA 2 ESMA | No | No | Yes |
| CRA 2 Own | No | No | Yes |
| CRA 3 ESMA | No | No | Yes |
| CRA 3 Own | No | Yes | Yes |
| CRA 5 ESMA | No | Yes | Yes |
| CRA 5 Own | No | Yes | Yes |
| CRA 6 ESMA | No | Yes | Yes |
| CRA 6 Own | No | Yes | Yes |
| CRA 7 ESMA | No | Yes | Yes |
| CRA 7 Own | No | Yes | Yes |
| CRA 9 ESMA | No | No | Yes |

74. Out of the nine respondents to the questionnaire, a total 13 sovereign rating actions were assessed from seven different CRAs. In these 13 cases, 13 actions were assessed as either being driven by, or having considered, ESG factors in the rating action. However, as can be seen from the breakdown, even allowing for this generous interpretation as to whether E, S or G factors were taken into account, in no cases were environmental factors considered. Unsurprisingly, given the relevance of Governance factors to sovereign issuers and the number of responses which highlighted Governance factors as the least challenging to quantify from the perspective of credit assessments, this was the most commonly assessed of the three factors.

Conclusion

75. With regards to the credit rating actions under both samples (ESMA and CRA own), an assessment of the rating actions was broadly consistent with the views expressed by CRAs in responses to the first question in the Questionnaire. Namely, that the consideration of ESG factors as either key drivers or as part of the whole range of factors in determining the rating, varies according to their relevance to the creditworthiness of the issuer, and that this relevance is determined by the underlying methodology. At the same time, these methodologies only consider ESG factors where the CRA has considered they are relevant to the category of entity from a creditworthiness perspective.
76. As a result, where sectoral methodologies prioritise certain factors over others as more relevant to creditworthiness, this is borne out in the rating actions themselves. This can be seen from the above analysis. A good example of this being, CRAs methodologies for assessing insurance and reinsurance entities are required to take greater account of environmental events and natural catastrophes given the immediate relevance of these elements to their business models. As a result, consideration or impact of E and G factors are more clearly borne out in these types of ratings than in other sectors. Likewise, for Sovereign ratings, where sovereign methodologies place a high weighting on social and governance factors in their sovereign credit assessments, the consideration of these factors is consistently and systematically borne out.

6. ESG Regulatory Developments and their Relevance for Credit Ratings

77. On 24 July 2018, ESMA received a formal mandate from the European Commission to provide technical advice to supplement an initial package of proposals¹⁴ adopted on 24 May 2018. The purpose of this technical advice was to recommend how the existing regulatory frameworks for Directive 2009/65/EC (UCITS Directive), Directive 2011/61/EU (AIFMD) and Directive 2014/65/EU (MiFID II) could be amended to include the integration of sustainability risks and sustainability factors. On 3 May 2019, ESMA published its Technical Advice on integrating sustainability risks and factors under UCITS, AIFMD¹⁵ and MiFID II¹⁶.
78. Specifically, these proposals mandate the inclusion of sustainability considerations by investment managers and investment firms, in their organisational and risk assessment processes. If adopted, it is reasonable to assume that these proposals will lead to an increased demand for sustainability assessments or sustainability characteristics. It is also recognised that this is only a small part of a broader trend among all financial market participants, for increased information and insight in this area. This leads to the question as to what products or information sources could be used by market participants to make these assessments.
79. One way of meeting this increased demand would be to amend the CRA Regulation to mandate CRA's methodologies to consider sustainability characteristics of rated entities regardless of their relevance to credit worthiness. The benefit of this approach would be to have credit ratings, which are a regulated product issued by supervised entities, fill this gap in supply of sustainability assessments.
80. However, given the role that credit ratings continue to play in EU financial legislation concerning the allocation of capital by financial institutions and given that mechanistic references to credit ratings in key pieces of sectoral legislation have not been removed such a change would not be advisable. In this context, it is preferable that credit ratings remain focused on assessing creditworthiness, and that information is provided by another category of product that provide undiluted assessments of an entity/s sustainability characteristics. By way of developments in this area, ESMA's Guidelines on Disclosure Requirements applicable to credit ratings are expected to improve the transparency of CRAs consideration of ESG factors in their credit rating press releases and reports. This

¹⁴ This initial package of proposals included proposals aimed at establishing a unified EU classification system of sustainable economic activities, improving disclosure requirements on how institutional investors integrate environmental, social and governance factors in their risk processes and a new category of low carbon benchmarks.

¹⁵ [ESMA Technical Advice to the European Commission on Integrating Sustainability Risks and Factors in the UCITS Directive and AIFMD](#)

¹⁶ [ESMA's Technical Advice to the European Commission on Integrating Sustainability Risks and Factors in MiFID II](#)

will enable market participants to better understand the relevance of ESG factors to an entity's creditworthiness.

81. Elsewhere, it is noted that a number of CRAs and non-CRAs are already introducing specific products to assess sustainability (so-called ESG or sustainable ratings). However, it should be noted that introducing regulatory requirements that create a reliance on a particular type of product, without introducing safeguards to ensure the integrity and reliability of those products, also entails a degree of risk.
82. As a result, and given previous negative experiences of over-reliance on credit ratings pre-financial crisis, it would be prudent for the Commission to assess whether new legislative requirements that may increase reliance on a particular type of product, such as ESG assessments, require some level of regulatory safeguards to mitigate any risks to investors and financial stability.

7. Conclusion

83. This Technical Advice provides an overview of current practices in respect of sustainability considerations in the credit rating market. It is based upon voluntary responses to a questionnaire submitted by ESMA to CRAs in September 2018. While ESMA sought to ensure that the CRAs contacted constituted a representative sample of EU CRAs, the conclusions of this Technical Advice should not be understood as a definitive assessment of the practices of all CRAs operating in the EU.
84. Given this context, this Technical Advice sets out the findings of this questionnaire, but does not seek to form a judgement on the responses received or take a view as to whether greater or lesser consideration of ESG factors should be taken within the credit rating actions that were assessed as part of the questionnaire.
85. This Technical Advice has found that CRAs are currently considering ESG factors in their credit ratings. Importantly, taking account of ESG factors in credit assessments is distinct from, and should not be confused, with sustainability assessments or sustainability ratings. Some CRAs and non-CRAs are developing specific products to assess sustainability characteristics, but these serve a different purpose as they do not aim to provide a credit opinion.
86. In addition, the prevalence and frequency by which these factors are being considered is dependent upon the underlying credit rating methodologies' determination of their relevance to the credit assessment of an entity, which itself is dependent upon the judgements made by the CRA as to what factors are relevant for a given methodology.
87. As a result, credit ratings should not be understood as providing an opinion on sustainability characteristics of an issuer or entity. This is neither the purpose of credit ratings, nor would it be consistent with their role and definition under the CRA Regulation. Given the specific

role credit ratings continue to occupy within the financial system, it would not be advisable to amend the CRA Regulation to more explicitly mandate the consideration of ESG factors in CRAs' credit assessments.

88. This being said, it is also recognised that, with a view to increasing transparency and assisting investors to conduct their own due diligence, it could be useful to update the CRA Regulation's disclosure provisions with regards to how ESG factors are being considered in credit ratings to ensure the CRA regulatory framework keeps pace with ESG developments in other areas. In this regard ESMA has already taken a first step to strengthening this framework through its Guidelines on Disclosure requirements applicable to Credit Ratings¹⁷. ESMA will monitor the impact of these Guidelines on CRA's disclosure practices with a view to informing any further steps in this area.
89. Finally, noting the increasing supply of and demand for sustainability assessments in the finance industry – whether provided by CRAs or non-CRAs – the Commission could consider the role that such assessments play and how they are being used. There may be a need to assess the necessity of providing regulatory safeguards elsewhere for those products and entrants into the market that are likely to arise from its push to encourage the consideration of ESG factors by market participants.

¹⁷ Final Report: Guidelines on Disclosure Requirements Applicable to Credit Ratings

Annex I – ESG Questionnaire to CRAs

Question 1. The manner in which [CRA] currently considers ESG factors within its credit rating activities.

[CRA] is requested to provide responses to the below questions:

- i. Please provide an overview of [CRA]’s approach to the consideration of ESG factors in its credit rating actions.

In providing your response, please refer to how the practices of [CRA] may have developed over the last five years, the challenges posed by the integration of ESG factors in your methodologies, models and key rating assumptions (with particular reference to differences in approach across asset classes) and your expectations as to how the consideration of ESG factors within your credit rating actions may develop over the next five years. This should include particular reference to the consideration of Environmental factors.

- ii. Please provide examples of where the consideration or integration of ESG factors is demonstrated within a selection of [CRA] methodologies, models or key rating assumptions.

In providing your response, please provide at least one example for each ESG factor.

- iii. Please provide examples of where the consideration of ESG factors is demonstrated within rating action disclosures (press release, sovereign research report etc.)

In providing your response, please provide examples of specific rating related disclosures which refer to whether and how ESG factors were considered as part of that rating action.

- iv. Please provide examples of published research that you have issued explaining how ESG factors are being taken into account within [CRA] credit rating actions.

In providing your response, for each of the items provided please explain whether and how the guidance relates to one or all of ESG factors.

Question 2. Whether and how [CRA] considered ESG factors within specific credit rating actions selected by ESMA.

With regards to each of the rating actions listed in Annex II please provide the following:

- i. The **principal methodology** used in determining the rating, as part of the rating action.
- ii. The rating committee material, including documentation containing the rating analyses produced for the rating committee (e.g. any file, template or other document used).
- iii. Any other internal documentation that was considered in the determination of the rating action, which was not part of the rating committee material.
- iv. In the event a rating committee was not convened for the rating action, please provide documentation of the rating analysis that was considered in the determination of the rating action.
- v. All published documents (e.g. press releases, published reports) concerning the rating action.
- vi. An indication of **qualitative** and **quantitative** ESG factors used in determining the rating, as part of the rating action.
- vii. References to **where** the qualitative and quantitative ESG factors indicated under point vi, can be found within the documentation provided under points i-v.
- viii. If **no** ESG factors were considered as part of this credit rating action, please explain the reasons for this, or alternatively, outline whether they had been considered as part of a previous rating action for this issuer.

Question 3. Whether and how [CRA] considered ESG factors within specific credit rating actions selected by [CRA].

For each rating action selected by [CRA]¹⁸ please provide the following:

- i. The **principal methodology** used in determining the rating, as part of the rating action.
- ii. The rating committee material, including documentation containing the rating analyses produced for the rating committee (e.g. any file, template or other document used).

¹⁸ In this regard please select six rating actions according to the same categories as those requested under Annex II, namely: 2 Non-Financial Corporates, 1 Financial Corporate, 1 Insurance Corporate, 1 Sovereign, 1 Structured Finance.

- iii. Any other internal documentation that was considered in the determination of the rating action, which was not part of the rating committee material.
- iv. In the event a rating committee was not convened for the rating action, please provide documentation of the rating analysis that was considered in the determination of the rating action.
- v. All published documents (e.g. press releases, published reports) concerning the rating action.
- vi. An indication of **qualitative** and **quantitative** ESG factors used in determining the rating, as part of the rating action.
- vii. References to **where** the qualitative and quantitative ESG factors indicated under point vi, can be found within the documentation provided under points i-v.
- viii. If no ESG factors were considered as part of this credit rating action, please explain the reasons for this, or alternatively, outline whether they had been considered as part of a previous rating action for this issue