ESG

Environmental, Social, Corporate Governance

Influence of credit relevant ESG factors
on fedafin's corporate ratings

May 2021

Introduction

For more than half a century, investment experts have debated the influence of environmental and social factors on corporate performance. On one side of the spectrum, Milton Friedman argued in the 1960s and 1970s that shareholders were the only group of people for whom a company had to be socially responsible. Accordingly, the only goal was to maximize shareholder returns (shareholder value). The other side of the spectrum, often represented at the time by philanthropists, had a broader understanding of a company's sense of responsibility. This encompassed all the effects of business activities on society, employees, the environment and the economic environment (stakeholder value). This gave rise to the three-pillar model of sustainable development around 1994, which states that sustainable development can only be achieved by implementing environmental, economic and social goals simultaneously and on an equal footing (triple bottom line).

The discussion is also highly political and continues. For some time now, the momentum has been on the side of sustainability, even though temporary and local countermovements can be observed again and again. Various milestones in recent history illustrate this:

1992 Rio Declaration with principles on sustainability
1997 Kyoto Protocol with targets for climate protection
2006 Start of Principles for Responsible Investment (PRI)
2008 First Green Bond issuance by the World Bank
2012 Rio+20 Summit with commitment to sustainable business & the Millennium Development Goals for 2015
2014 First version of the Green Bond Principles by the International Capital Market Association (ICMA)
2015 Passing of the 17 Sustainable Development Goals to be met by 2030 by the UN
2015 Start of the Task Force on Climate-related Financial Disclosures (TCFD) by the Financial Stability Board
2015 Paris Agreement with the aim of climate protection as successor to the Kyoto Protocol
2017 First version of the Social Bond Principles by ICMA
2019 European Green Deal (reducing net emissions of greenhouse gases in the EU to zero by 2050)
2020 Passing of the EU Taxonomy Regulation, which defines criteria for determining the sustainability of an economic activity or an investment

While we do not participate in the ideological and political debate, we follow it closely since the related social trends and political decisions may well affect the creditworthiness of entities we rate.

In addition, as an independent credit rating agency operating at the nexus of investors and capital seekers, we feel an obligation to be transparent with market participants about our approach to ESG, which is why we signed PRI's "Statement on ESG in credit risk and ratings" in August 2018.

PRI is an investor initiative in partnership with the United Nations Environment Programme Finance Initiative and the United Nations Global Compact. Together with its international network of signatories, PRI is dedicated to putting the six principles of responsible investing into practice. The goal is to better understand the impact of investment activities on environmental, social and governance issues, and to help signatories integrate these issues into their investment decisions.

Having long focused on equity investments for sustainable investing, PRI has also turned its attention to the debt market. Credit rating agencies and their assessments of creditworthiness play a critical role in this environment. By signing the "Statement on ESG in credit risk and ratings", we share a common vision to improve the systematic and transparent consideration of ESG factors in credit ratings.

Credit Rating Agency vs. ESG Agency

It is important to note that, as an independent credit rating agency, we continue to give our opinion exclusively on the probability of default and related parameters such as loss given default or expected loss in the form of credit ratings. This is the key distinction from ESG agencies, which assess companies exclusively or mainly on the basis of ESG criteria, while the question of probability of default plays no or only a subordinate role.

Various studies[1] have shown that the assessments of ESG agencies are only weakly correlated, while creditworthiness analyses of credit rating agencies are very strongly correlated. In our view, this is due to the fact that, on the one hand, the data basis for credit ratings is available and is generally of high quality and, on the other hand, the objective, namely to forecast the probability of default, is unanimously clearly defined among credit rating agencies.

In contrast, ESG agencies differ significantly, particularly in their objectives. Depending on ideology, methodology and weighting, the same company can receive different ESG scores from different ESG agencies. For investors, it is therefore crucial to know the respective ESG methodology in detail and to check it for consistency with their own investment philosophy.

Rating Concept

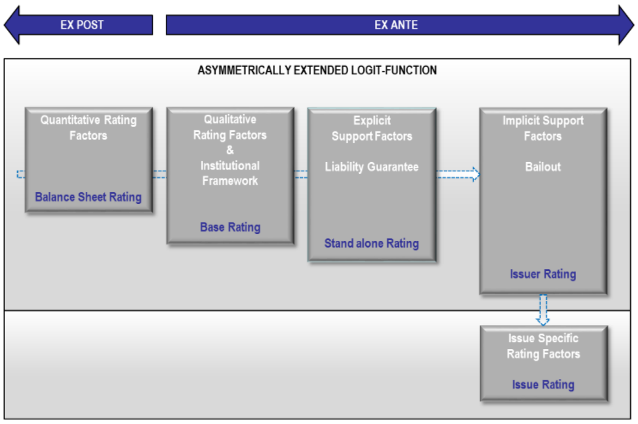
Our credit rating architecture basically consists of four modules and allows us to consistently and flexibly consider factors that systematically influence the credit rating of companies in various market segments and sectors. We capture credit-relevant ESG factors in modules 2 to 4 (see Figure 1). A logit function asymmetrically extended by several company-specific parameters serves as the methodological basis for evaluation, which realistically depicts the dynamics of creditworthiness risks. With regard to the traditional definition of default risk, we distinguish between the stand-alone rating (without implicit support) and the corporate rating (with implicit support) and show these transparently on the corresponding credit rating report.

In the case of private companies, stand-alone ratings and corporate ratings are usually identical, as there is no support or guarantees. In contrast, the conceptual distinction

[1] e.g. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3829831, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533, https://am.vontobel.com/en/insights/navigating-with-esg-ratings-what-you-need-to-know, or https://www.fuw.ch/article/__trashed-154/

between stand-alone rating and corporate rating is significant in the segment of public-sector companies, even if they are organized as stock corporations under private law. While the stand-alone rating also considers explicit guarantees from third parties in their various forms, the corporate rating can at most additionally benefit from implicit support from the public sector as the owner or guarantor of a company.

In the case of both public-sector and private companies, guarantees or support probabilities that exist due to the shareholder structure are included as a G-factor in module 3 (explicit) or in module 4 (implicit).



1 Rating concept for the credit assessment of companies

Quantitative Rating Criteria

Credit ratings are generally based on selected financial ratios from previous years (Module 1; ex-post situation). Strict criteria are applied to the selection and construction of the respective ratios. These include direct relevance to creditworthiness, clear ranking, objective comparability (i. a. adjustment for obligations from operating leases), extensive resistance to manipulation (i. a. change in accounting standard) and statistical robustness.

The financial ratios are parameterized using numerous model validation test procedures. As part of the credit rating process, three creditworthiness-relevant facts in the financial autonomy and sphere of influence of a company are fundamentally relevant (without being exhaustive; depending on the industry, sector-specific ratios are included):

Assessment of capital structure and liabilities

- Equity
- Net liabilities
- Liabilities structure
- Goodwill ratio

Assessment of earning power and profitability

- EBITDA margin and EBIT margin
- Return on sales
- Return on assets

Assessment of liquidity and cash flow

- Cash ratio and quick ratio
- FFO and operating cash flow
- Free cash flow
- Depreciation ratio

Qualitative Rating Criteria

In addition to selected financial ratios, the credit rating includes an analysis of factors that have an influence on the sustainability and stability of a company's performance. These risk factors allow conclusions to be drawn about the future development of a company's creditworthiness (module 2; ex-ante trend). The assessment is supplemented by the analysis of other factors which, among other things, allow systematic conclusions to be drawn about a company's relative competitive position vis-à-vis its peers or its future capital structure.

Qualitative risk and success factors are systematically identified and evaluated by the credit rating team and subjected to critical review by the credit rating committee. These have always included strengths and opportunities or weaknesses and risks that are subsumed under ESG and those that are also material but cannot be assigned to the ESG area. As part of the credit rating process, issues relevant to creditworthiness are fundamentally relevant in three corporate areas (without being exhaustive):

Institutional framework

- Market structures and barriers to competition
- Political and regulatory risks
- Cyclicality and growth prospects of the industry

Corporate structure and strategy

- Diversification and innovations
- Investment cycle and acquisition policy
- Complexity of corporate and business structure

Capital structure

- Subordinated and/or secured debt
- Shareholder loans

Outlook

We currently count the following thematic blocks among the potential risk and success factors under ESG:

E: Resource consumption, emissions, innovations, biodiversity, CO_2, waste, water

S: Human resources, human rights, society, product responsibility, customers, human capital, security, social cohesion

G: Shareholders, management, corporate social responsibility, reporting, corporate structure, transparency, values

However, the subsuming under the umbrella term ESG is not left to us, but is part of the socio-political discourse mentioned earlier. ESG is and remains a dynamic field without a conclusive list of facts. What was relevant to ESG ten years ago is different from what it is today, and even today's definition will continue to evolve over the next ten years.

Particularly relevant for us in this context is the question of the materiality of an ESG factor. Here, it is not ideological considerations that play a central role, but purely economic ones. The focus is therefore on the question of whether and to what extent an ESG factor will positively or negatively influence the result of the quantitative analysis of the credit rating in the future.

For example, sustained changes in consumer behavior could boost or reduce a company's sales by increasing or decreasing demand or by supporting or undermining its pricing power. Likewise, declines in sales are conceivable as a result of reputational damage, because external costs are not or only insufficiently internalized.

Regulatory changes and tightening frequently influence the cost side. Worth mentioning, for example, are excerpts from the measures adopted by the Federal Council in December 2020 for a more sustainable orientation of the Swiss financial industry:

- Development of a binding implementation of the TCFD recommendations for Swiss companies
- Possible adjustments in financial market law to prevent "greenwashing", i.e. pretending to do sustainable business in the environmental sector
- Recommendation to financial market players to publish methods and strategies on how climate and environmental risks are considered when managing the assets of their clientele

Besides this, popular initiatives (which often have no chance of success) can also have an impact. Only recently, Switzerland rejected the popular initiative "For responsible companies - to protect people and the environment" (corporate responsibility initiative). This will soon be followed by the popular initiatives "For clean drinking water and healthy food - no subsidies for the use of pesticides and prophylactic antibiotics" (drinking water initiative) and "For a Switzerland without synthetic pesticides" (pesticide initiative), which may have credit relevance.

This also shows that the legal environment in which a company operates is decisive for the question of materiality. Our monitoring therefore covers the entire impact area of an evaluated issuer. One example in this context is the "Sustainable Corporate Governance" directive planned by the EU Commission. It goes in the direction of a "supply chain law" and is thus a kind of counterpart to the Swiss corporate responsibility initiative.

Efforts are being made worldwide to achieve a more sustainable economy. As a result, a fundamental partial internalization of external costs that have so far been borne by the general public can be expected in the future, both at home and abroad. In addition, the management of public goods such as the climate via taxation, quota systems, etc. is likely to increase.

Excursus: Credit Rating Report

Any influence of ESG factors on the credit rating is disclosed transparently and separately in the credit rating report. An excerpt from Axpo's credit rating report[2] serves as an example (see Figure 2).

In a first step, we indicate the overall impact of ESG factors on the credit rating as "neutral", "positive" or "negative". This reflects that all considered ESG risk and performance factors in total have no, a positive, or a negative impact on the credit rating. It is important to understand that this is not an ideological evaluation or assessment. It is exclusively a matter of impact on the probability of default.

ESG	
Impact	**positive**
positive	**Hydropower, shareholders**
negative	**Nuclear energy**

2 Disclosure of the ESG influence on the credit rating report

We then list under "positive" or "negative" in key words each ESG factor that we have classified as material in the context of the credit rating assignment and have therefore considered, and which have led to the overall ESG impact on the credit rating described above. Using Axpo as an example, this reads as follows:

- The overall ESG impact on the credit rating is positive.
- Hydropower and shareholder structure have a positive material impact on the credit rating.
- Nuclear energy has a negative material impact on the credit rating.

Other ESG issues may exist, but are not reflected in the credit rating due to a lack of materiality. In addition, other risk and success factors may have a material influence on the credit rating, but are not ESG-relevant. In both cases, no separate disclosure is made. ■

[2] Axpo's entire credit rating report can be downloaded for free under https://e-rating.fedafin.ch/.

Contact

fedafin AG
Galerieweg 8
9443 Widnau
Switzerland

Phone: +41 71 552 32 00
Email: info@fedafin.ch
Website: www.fedafin.ch

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