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Delivering deeper ESG integration in FI

Insights from the CRISIL GR&RS and S&P Global Sustainable1 webinar on the ESG integration in fixed income

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Getting ESG integration in FI right

CRISIL and S&P Global Sustainable1 co-hosted a webinar on *ESG in fixed income: Navigating the next phase of sustainability* on May 10, 2022. More than 125 delegates from the buy-side, the sell-side, and commercial banks attended the event. The panelists included Carmen Nuzzo, Head of Fixed Income at the Principles for Responsible Investment (PRI), Susan Hutman, the Director of Investment Grade Corporate Credit Research and Director of the Fixed Income Responsible Investing Strategy at AllianceBernstein and Martin Staeheli, Senior manager of ESG Research at S&P Global. Abhik Pal, Global Head of Research Practice at CRISIL GR&RS, moderated the discussion. Here we summarise the key insights from the discussion.

Part 1: Regulatory push on the forefront

Shifting gears: Regulation and climate events driving ESG integration

- **Gradual progress since 2015:** The process to integrate ESG factors in fixed income (FI) had started gaining momentum very gradually from the middle of the past decade. The key factors that provided an impetus included the Paris agreement, launch of Task Force on Climate-related Financial Disclosures (TCFD) and Sustainable Development Goals (SDG), movement initiated by Greta Thunberg, European sustainability regulations and Green Bond Principles.
- **Regulations force changes:** ESG integration in credit markets is still evolving globally. In many cases, it is regulation that is forcing the changes in transparency and reporting the standards. Regionally, Europe continues to lead by bringing about regulatory changes. There is significant momentum in North America and even in Asia and Latin America, too.
- **Frequent climate and weather events:** Increasing frequency and magnitude of accidents related to climate change and extreme weather is sharpening the focus on ESG.

Global regulators focused on product transparency

- **What and how:** Global regulators are trying to address the widening world of ESG strategies and are focused on transparency for asset managers (AMs). There are two focus areas — the commitments made by AMs to make their funds sustainable and then ensuring its implementation in line with commitments.
- **Articles 6, 8, 9 funds provide strategy designations:** Some regulators in Europe and Asia are trying to define or categorise different ESG funds with labels. The articles 6, 8 and 9 classifications outlined in the Sustainable Finance Disclosure Regulation (SFDR) are strategic designations that give managers a chance to identify and disclose what their approach is to ESG and sustainability. Europe is going a step further trying to use the investment industry to direct capital flows towards sustainability.
- **SEC focuses on truth and advertising:** The panel sees the Securities and Exchange Commission (SEC) looking for enhanced disclosures on integration and how the integration is done. The hope is that it will translate into better transparency about philosophy, process, and metric for ESG integration.

Part 2: Systematic integration is the need of the hour

FI managers should embrace explicit and systematic ESG integration

- **Explicit, systematic integration an urgent need:** FI investors have, to an extent, always integrated ESG factors into their bond valuations, especially when it comes to governance. However, now there is a need to integrate climate and other factors explicitly and systematically in their investing frameworks.

- **Risk- and outcome-based approaches dominate:** Investors currently adopt varied approaches to integrating ESG in their investment decisions. Some adopt a risk perspective to mitigate ESG risks, including credit risk. Others take on an outcome-oriented approach and invest in thematically or target-specific environmental or societal objectives. The approaches are not mutually exclusive and mostly overlap.
- **Investment mandate, a key constraint for AMs:** The ESG investment approach adopted by investment managers is constrained by the mandates they receive. The investment horizon varies as certain themes or risks are more aligned with longer term risks. In short-term bonds or securities not held until maturity, identifying the ESG trends is difficult.

AMs adopting own ratings; modelling ESG risks without historical data is a problem

- **Huge confusion in ESG ratings:** In the case of credit rating agencies, the ratings differ by one or two notches but is broadly aligned as inputs they get are similar. In contrast, the market is extremely confused about what ESG ratings are and what they measure. While credit rating agencies can rate an issue, ESG ratings are more related to the ESG standards of the issuers, and their profiling based on their ESG credentials.
- **Non-alignment is not bad if we understand the methodology:** The ESG ratings are produced by third parties and are not regulated, which is crucial because their methodology may be less transparent. The non-alignment of ESG ratings may not necessarily be a bad thing as long as it is clear what they reveal, and how they're computed and measured. The regulators are trying to investigate divergence. Institutions such as PRI are also addressing this through the outreach with investors, credit rating agencies and service providers.
- **In-house scoring among large AMs**: Large AMs — especially the sophisticated ones — are dealing with the ESG rating dispersion based on their own calculations. This adds to even more dispersion. This is problematic as AMs must justify to their clients as to why their ratings might be different from third party ESG ratings.
- **Modelling unknown unknowns is a problem:** ESG data availability has come a long way in the past 10 or 15 years. Investors now struggle to make sense of the data and understand which of them are financially material and which are not. There is a lot of debate about the lack of people, data, and time series. But we are also now trying to model and face uncertainty that we have never dealt with before. We are trying to predict trends or events that have never occurred in the past.

Part 3: Data challenges remain

Company structure impacting ESG awareness, EMs face structural ESG headwinds

- **Impact of company structure significant:** Company structure (family-owned or private equity or listed) impacts ESG awareness or involvement more than credit quality. Smaller firms have fewer resources and may not be good at communicating their ESG agenda or maybe positioned in niche markets. This complicates comparison because of lack of availability of data and comparability.
- **ESG themes are a bigger issue in emerging markets (EMs):** EMs are relatively more dependent on coal and traditional fossil fuels and have significant exposure to physical climate risks. Given these structural constraints, investors need to be careful about not penalising emerging markets while ranking. They should rather work with these countries towards achieving sustainable solutions.

ESG data availability among smaller and non-listed firms to improve

- **ESG disclosures and ratings are still developing:** Only 30% of the listed companies have effective ESG disclosures. Moreover, there are substantial gaps that grow wider as we move towards smaller listed companies. Even among large, listed universe, firms have challenges in providing standardised metrics, such as scope-1 and -2 emissions and non-renewable energy consumption. ESG disclosures by non-listed companies, which had been low, have improved of late.

- **Convergence, EU rules and CSRD to drive up availability:** Growing convergence of disclosure standards and digitalisation will enhance data availability going forward. The SFDR will help standardise ESG information used by financial market participants. This will also drive demand for standardised disclosures from companies. The new taxonomy regulation in the EU allows investors to look at the impact of companies' business activities on the environment. The corporate sustainability reporting directive (CSRD) expected to come into force in 2023 in EU will push for more standardised disclosures. While it will impact large, listed companies first, smaller, and non-listed companies will also come under its ambit later.

Assessment of social dimension has come off age

- **Covid-19 and great resignation have brought 'S' to the forefront:** The pandemic and developments such as the Great Resignation and many other issues, such as diversity, equity, and inclusion, have shown the importance of the social dimension for successful business.
- **Right mix of qualitative and standardised quantitative factors:** The quantitative data about social parameters is not as good as in the environmental criteria. However, now there is enough data for investors to get a pretty good picture of how companies fare on the social front. The key qualitative information on social dimension includes policies, systems, human rights, and due diligence approaches. The quantitative information on employee turnover, engagement rate, and equality of pay is more standardised than other diversity indicators.

Part 4: Operationalising ESG Integration across FI

Proprietary research essential to alpha and differentiation

- **Proprietary research key to sustainability alpha:** ESG integration based on in-house ESG research is essential to delivering superior risk-adjusted returns, recognising that there are various approaches to ESG analysis by the largest third-party providers. Having the in-house-developed bottoms-up integration framework, data and technology tools that draw on that research is the best way for AMs to ensure that the investable universe is aligned with the portfolio objectives at first. After that, AMs optimise the research outcome across all client-mandated objectives while delivering performance.
- **Prop research crucial for differentiation:** Investment managers may have very different objectives with respect to sustainability. Proprietary approach to ESG research and labelling of bonds will be important and will be an important differentiator across managers.
- **Embed ESG upfront in investment process:** In the bottoms-up credit research influencing default risk, ESG analysis needs to be embedded upfront in the investment process. It cannot be an something that AMs assess after a portfolio is already constructed. Also, managers need to comply with evolving regulation. Their philosophy, process, and metrics have to be more transparent to prove that they are integrating ESG as stated.

Corporate credit: uniform sector-level ESG approach is key

- **Europe has been a driving force influencing developed market (DM) credits**. Corporates in both developed and emerging markets have seen improvement in sustainability reporting and issuance of green and sustainability-linked bonds.
- **Uniform sector-level ESG frameworks for credits:** As a best practice, the leading AM has adopted a uniform approach to integrating ESG and corporate credit analysis. Credit analysts across developed and emerging markets and private placements across credit quality have developed ESG frameworks that focus on material risks and opportunities of the specific sector. The outcome of the ESG analysis is then embedded into issuer ratings and default risks. This also helps the analysts/PMs to assess if the credits meet the criteria to be included in the sustainability-focused portfolios or if the spreads are adequately compensated for the ESG risks.

Municipal bonds: Not all of them are ESG angels, issuer level analysis is a must

- **No golden source for muni ESG ratings:** Integration of ESG into municipals needs a systematic approach given the sheer size of issuers. There is no golden source for ESG data related to munis. AMs need to develop own solution complemented by information from multiple providers. Extensive data clean-up and mapping is required to feed the information into a systematic process.
- **Exposure to positive ESG services is advantage but all not well run:** Some think that by design the muni market is all focused on ESG opportunity as a large portion of it concentrates on positive ESG services such as education, healthcare, and public utilities. However, the truth is that not all hospitals and schools are well run. Evaluation and detailed assessment of issuers is required to distinguish the sustainability profile of municipal bonds even though there is a natural tilt towards positive ESG opportunities.
- **Need to set minimum thresholds for inclusion:** Even though the municipals sector is focused on public goods, investors will need to set minimum thresholds for inclusion in the portfolio. For example, minimum requirements for free and reduced meals in primary and secondary education, investor will need to assess the percent of students qualifying for Pell grants and higher education and healthcare. Municipal issuers also need to see whether they have sizable representation from Medicaid and charity care in the pay mix. Investors need to track those performance indicators over time to measure the impact.

Sustainable bonds: Bespoke approach key to scrutinize credentials

- **Own due diligence to complement third parties:** AMs can use the available third-party data and certifications. However, it is important to conduct own due diligence and take popular approaches, including ICMA, the EU taxonomy, the climate bond initiative and Sustainalytics.
- **Comprehensive proprietary framework**: The proprietary framework assesses several things, including ESG controversy analysis, areas of use of proceeds, appropriateness of targets evaluation of harm in other respects. For instance, a hydroelectric project financed through green bonds could affect severe damage to the surrounding environment and communities.
- **Credentials reiterated by issuer strategy:** It is important to understand if the company plans to issue more ESG-label bonds down the road. Follow-up issues contribute to a more robust ESG bond market and holds the firm accountable in a much larger way instead of riding the GreenWave with a one-off deal. Issuers who pass all the tests and have a structured ESG labelling are provided a three to five basis point Greenium.
- **Holdco vs opco – look out for incentives and decision-makers:** Investors face challenges, especially in complex capital structures where there is a holding company (holdco) with multiple operating companies (opcos). It is important to assess the risk and opportunity at the opco to which you are lending. However, it is critical to understand factors that can influence decision-makers and prompt change. Investors need to engage both with opcos and holdcos, depending on how capital flows are directed and how decisions are made. They need to evaluate the incentives and motivations right across an organisation and make sure that they are talking to all the people who can have influence the outcomes.

PE firms: Leverage direct access and structure focused approach

- **Direct access to data can bridge gaps in disclosure:** Like conventional AMs, PE firms also can integrate ESG ratings, data, and products or mechanisms such as sustainability-linked loans or green bonds. With significant stakes in companies, PE firms are well placed to drive ESG disclosures. They also might have direct access to data that are not publicly available.
- **Need to accommodate size and disclosure requirements in assessments:** PE firms can tap third parties utilising the data directly obtained from the companies to conduct sustainability assessment. Firms need to pay attention to the size (micro and nano capped non-listed companies) and the different disclosure requirements while conducting assessments.

Sovereigns: Multi-dimensional country models to determine selection

- AMs have developed a systematic framework for sovereigns. This framework is applied uniformly across developed and emerging countries. The goal is to derive insight into the ESG drivers (utilization of natural resources and labour) of long-run macroeconomic performance, which is about enhancing sovereign credit analysis.
- **Focus on drivers linked to natural resources, labour and governance:** On the environmental side, investors need to assess the susceptibility to natural disasters that can limit or boost economic growth. Within the social dimension, the factors include demographics, education and employment. Freedom and fundamental rights, human development, and equality indirectly influence the social factor. They all influence both the quantity and quality of labour. Strong governance factors (such as corruption, government power and law and order) lead to more sustainable external and fiscal balances.
- **Country-level ESG score can influence selection:** In EMs, as a best practice, sovereign ESG scores are used as direct input into the credit scoring model for countries. This can influence country selection. While DMs don't have a credit score, ESG scoring is used as an input to form a view on growth, inflation and rates. The model also incorporates factors, including demographics, de-globalisation and political turmoil (such as Brexit, rising trade tensions, Ukraine invasion, etc).

Part 5: Preparing for change - engagement and net zero

FI investors need to reset engagement mindset

- **FI investors need to change their mindset:** Lack of voting rights has been one of the reasons why FI investors have been relatively late in embracing responsible investment practices. This mindset needs to change. Bond investors don't participate in AGM or use voting rights, but they still can engage with issuers.
- **Engagement is fundamental to enhance diligence:** Engagement improves through regular meetings and conversations. Investors can ask for more data and seek clarifications about any missing information. This can happen either individually or through collaboration with other investors to drive outcomes. Many investors remained invested in companies because of their trust in the management evolved through longstanding conversations with the management.
- **Sharing research notes:** Sharing of research notes among equity and fixed income analysts could be considered a best practice. AMs also should do joint engagements as the material ESG issues translate to fundamentals regardless of strategy.

Shifting to a net-zero portfolio

- **Managers have committed to net zero but will not easy:** Many are still getting their heads around the net-zero commitment and how to embed it in portfolio construction. Most of the work is being done at the corporate level; in public finance, it is almost non-existent. This is because there is no carbon accounting or no TCFD disclosure for sovereigns. Whatever is needed must be implemented fast because the challenge is that we have very little time. Even if most net-zero targets are now set by 2050, it is less than 30 years away.
- **Measurement first, decarbonisation next:** At present, FI investors are trying to measure carbon footprint of their portfolios even before thinking about how to decarbonise their portfolios. In order to decarbonise, some are building a portfolio with companies that already have a very low carbon footprint now or are tilting their portfolio towards companies that produce climate solutions.
- **Proactive engagement required for portfolios with bet on transition:** If you invest in companies that have a high carbon footprint today, but with good plans or with good targets, you need to wait a long time until they make progress for your portfolio to look better. This requires detailed sustainability assessments and engagement with the issuers. The plans and targets need to be monitored and tracked and FI investors need to be more proactive. They must engage with borrowers and seek clarifications about their funding policies, strategies, and goals by working with them on new funding solutions.

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Argentina | China | Hong Kong | **India** | Poland | Singapore | UK | USA | UAE
CRISIL Limited: CRISIL House, Central Avenue, Hiranandani Business Park, Powai, Mumbai – 400076. India
Phone: + 91 22 3342 3000 | Fax: + 91 22 3342 3001 | www.crisil.com
/company/crisil @CRISILLimited /CRISILLimited /user/CRISILLimited /lifeatcrisil

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