Aberdeen Standard Investments

Embedding ESG considerations into the credit investment process

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An analytical framework focused on materiality and timeframe.

Contents

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Introduction

Much has been written on the importance of environmental, social and governance (ESG) in the investment processes of fixed income investment managers and other professional investors. Many claim they fully embed ESG into their research and end-to-end investment process. But what does this really mean? Does it make a difference and how does the end investor know whether ESG aspects are really being embraced or simply being used as a marketing tool?

The credit team at Aberdeen Standard Investments (ASI) welcomes the growing focus on ESG. As it becomes more commonplace in the investment language used by the owners of capital, the more likely we will be to see it becoming embedded in investment culture. From our perspective, embedding ESG is closely aligned to effective risk management. A good credit analyst will want to understand, model and forecast the key risks which could impact a debt issuer's credit quality. From this perspective then, ESG is just a label or classification of certain risks. It seems strange then that much of the published ESG research literature does not always fully address the core aspects of analysing 'risks', namely 'impact' (materiality) and 'timeframe'. We believe this is why many market practitioners and investors struggle to articulate how ESG actually influences investment decision-making despite claims of being 'embedded'. For example, ESG ratings or scores may be used. However, outside of a relatively simplistic exclusion approach, how such an ESG score actually drives transactional decisions is often more difficult to evidence. Ultimately this is because such risks are not straightforward to assess.

Third-party ESG data providers can provide useful data. In much the same way that credit analysts use financial statements to assess the riskiness of a company's financial profile, good quality data is required to make worthwhile risk assessments on ESG matters. However, many of the outputs from data providers seem focused on identifying 'good' or 'bad' practices (e.g. extent of compliance with regulation), or applying a checklist to measure certain exposures. Often with incomplete or out-of-date data, these outputs can then sometimes be combined into an overall rating or score. But what does this actually represent? Who is it designed for (equity investors, credit investors, government agencies etc.) and does it give a true sense of the materiality and timeframe of ESG risks from a credit perspective? In our experience, this kind of specificity is often lacking in practice.

Our approach

When we conduct our credit research on corporate bond issuers, the analytical output is multifaceted. In addition to setting traditional recommendations (buy, overweight, sell etc.), we require analysts to express a forward-looking view of the quality of the credit profile (a 'fundamental credit assessment'), a trend indicator (akin to an outlook, expressed as 'improving/stable/deteriorating') as well as, importantly, an ESG risk rating (low/medium/high). Our ESG risk ratings are credit profile-specific – and represent how impactful we believe ESG risks are likely to be to the credit quality of the issuer now and in the future. A 'high' ESG risk rating indicates that there are potentially significant risks whose impact and timing could negatively impact the credit profile. As a result, our 'fundamental credit assessment' (incorporating all risk factors) will also be impacted, as will the spread/yield/price we judge will be needed for us to be compensated for the risk of taking exposure to the issuer. Of themselves, ESG risk ratings are not entirely unique. Credit rating agencies and other investment managers also assign ESG scores or ratings as part of their research. However, to enhance their usefulness and applicability we have recently deployed an analytical '**ESG Risk Rating Framework**' which we can apply globally and across the credit spectrum.

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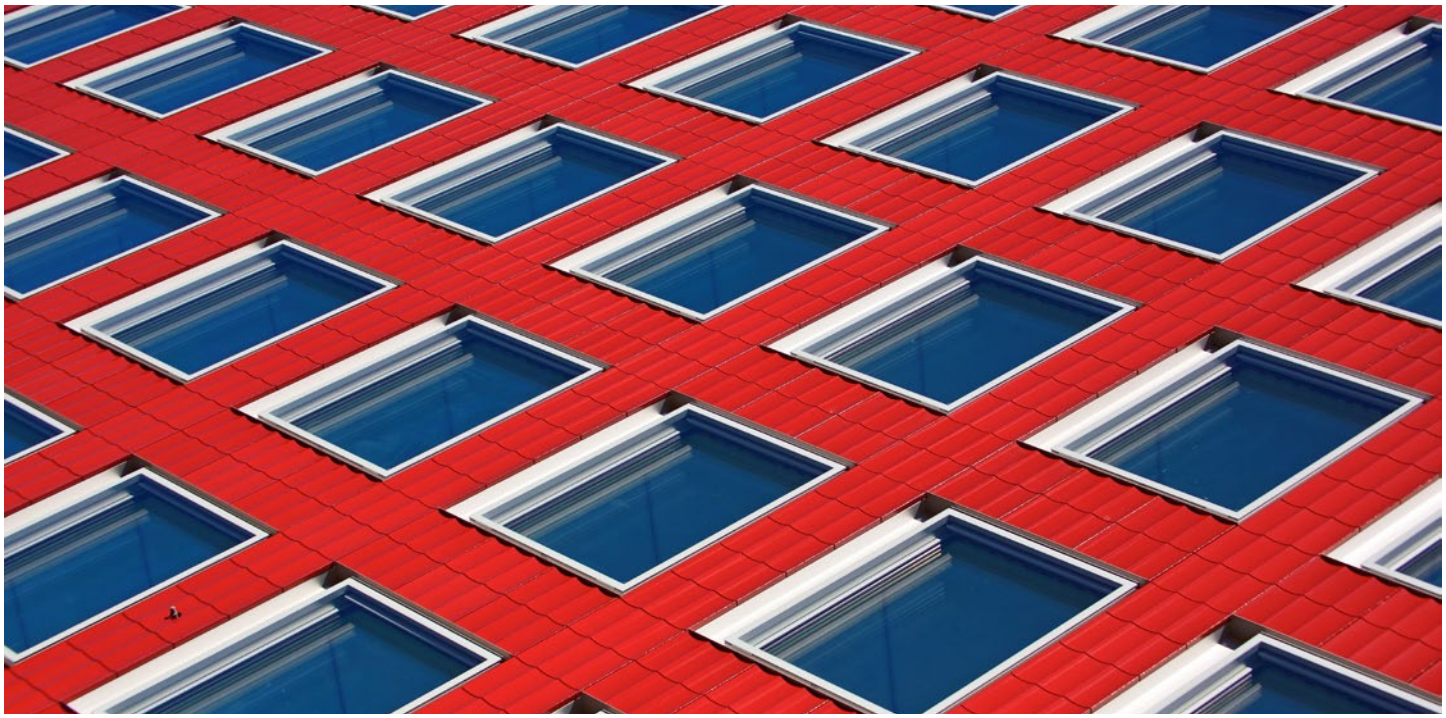

ESG Risk Rating Framework

The ESG Risk Rating Framework is a proprietary tool developed by the credit team in combination with the central ESG Investment team at ASI. We designed it to help focus the knowledge and expertise of our credit analysts in a systematic way that helps substantiate the overall ESG risk rating (low/medium/high) assigned to a debt issuer. The framework is based on a sectoral analysis, covering all corporate and financial sub-sectors, identifying those environmental and social risks that a generic company operating in a particular sector is likely to have to face and manage. Identification of these risks is based on the Sustainable Accounting Standards Board (SASB) Materiality Map[1] (materiality.sasb.org), and ESG sector risk assessments and 'heat maps' from two of the major credit rating agencies (Standard & Poor's and Moody's).

Within each risk category of 'environmental' and 'social', more granular risk factors are listed (e.g. greenhouse gas emissions). Using the experience of the credit team and the central ESG team, an initial indication of the **impact** and the **timing** of these granular risks is devised. This means that when any company is assessed under the framework, there is a pre-defined sector starting point (i.e. a suggested set of likely ESG risks broken out by impact and time-frame). As an example, take the environmental risk referenced above (greenhouse gas emissions). For a car manufacturer, the sector starting risk indications are 'high impact' and 'short term' (to reflect the importance of carbon emission regulatory targets and the negative financial impact of the fines for missing these). For a real estate company this risk is 'low' and 'medium term', whereas for a consumer finance company this risk is not flagged at all as having a major impact on its credit profile (in isolation). It is the responsibility of credit analysts to work through the framework, risk by risk, to determine whether the sector starting assessment is appropriate given the idiosyncratic aspects of the company in question. For example, it may be the company is quite 'generic' for its sector, and hence requires little adaptation. However, in the modern world it is our experience that this is becoming less typical. Corporate structures and business models have had to adapt (and will continue to adapt). This means that while a sector 'label' might still be an appropriate categorisation, the underlying operations of the company may mean it faces quite different or additional risks to its peers. Banking is a good example of where the sector starting point may not be appropriate in every case. Under the SASB Materiality Map there are no environmental risks flagged as a potential issue (at the time of writing). We would disagree with this, however, and continue to see increased focus and work at these institutions on analysing their environment impact, for example through their lending practises and commercial activities. Furthermore, increasing regulatory scrutiny of banking institutions does mean that there is potential for the associated risks to impact a bank's credit profile.

[1] The Sustainable Accounting Standards Board Materiality Map is an interactive tool that identifies and compares disclosure topics across different industries and sectors.

Timeframe and judgement

It is worth considering in more detail the importance of the timeframe judgement in our ESG Risk Rating Framework. Above we referenced risks as potentially having a short, medium or long-term impact. For consistency, we have defined 'short term' as two years or less (i.e. approximately the typical horizon for credit ratings assigned by a rating agency). 'Long term' is ten years or more. In this regard, it is worth noting that many 'long duration' credit products have bonds that mature after a similar period. Medium term is the difference (i.e. two to ten years). An obvious question is, "**is there a science to forecasting when an ESG risk will have an impact?**" to allow classification of the appropriate time category (short/medium/long). Analysts try to forecast financial data and ratios for multiple years into the future. Realistically anything longer than two years is difficult to place high confidence in. However, the mechanics and processes behind the convention of many years of forecasting financials can also be applied to ESG risks, even those where the impact will almost certainly be longer term (for example in the case of stranded assets), namely: historical trends, stress tests and scenario analysis, incorporating new data whenever it becomes available.

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In all these cases judgements are needed. In our experience, the way to improve such forward-looking judgements is to have a diversity of views, to leverage expertise from other asset classes (e.g. equity and real estate), and to take a global perspective (what happens in Asia may next happen in Europe etc.). To achieve this, in short, lots of research work makes a big difference. In an ESG context that means analysts undertaking relevant qualitative and quantitative research to help judge the likely timeframe of risks. By splitting out ESG risks individually, by both impact and timeframe factors, we believe the accuracy of our predictions will improve over time. Our judgements, in particular around timeframe, will benefit because they are expressed in a common framework, supporting back-testing across industries and geographic regions. Furthermore, with over 80 credit analysts globally, we will generate lots of judgements to inform this type of backtesting analysis.

All investment managers seek to get things right as much as possible, but it is often the timing element that is the most challenging.

At ASI we think it is better to be realistic and create a tool which allows credit investors to apply their own best judgement (and for this to be peer reviewed), but express these judgements in a common framework that enables learning from past mistakes.

Governance

Unlike environmental and social risks, the more granular governance risks in the framework are not pre-populated, except for country of domicile. It is the experience of our in-house Corporate Governance team that governance standards can be materially different from one country to the next, given local laws, regulations and common practices. Using in-house sovereign, economic and ESG expertise, each country has been mapped to low/medium/high (impact) and short/medium/long-term (timeframe) categories, in keeping with the overall framework. For example, a country with generally high corporate governance standards would be assigned a low impact score with a long-term timeframe designation. By contrast, a country with poor general standards (e.g. political instability, potentially resulting in corruption or bribery at the corporate level) may be mapped as high impact/short term. Aside from this, all other governance risks are populated by the credit analyst owing to the idiosyncratic nature of how companies are managed and their respective oversight arrangements. These risks include the level of financial transparency, complexity of the company structure or ownership, the existence of suitable risk committees/structures and disclosures, as well as the quality of management, their track record, strategy and capital allocation intentions. As for environmental and social risks, each governance risk is expressed in terms of potential impact and timeframe and these are assessed on a forward-looking basis. In a governance context, a good example of an area where this can be material is how a management team intends to use free cash flow. Will they, for example, use it to benefit all stakeholders including staff and broader society, as well as equity and bondholders?

Engagement

Our final example highlights another key aspect of ASI's ESG Risk Rating Framework. In order for judgements to be forward looking in nature, analysts need to actively engage with debt issuers to gain more information and to influence positively. Given the types of specific risks reflected in the framework, the level of detail in engagement meetings has been continually increasing.
Rather than generic ESG statements, analysts using the framework will delve into questions covering issues such as energy management, handling of waste material, labour practises and cyber risk management. This has multiple benefits. Not only does it help us improve our utilisation of the framework and provide substantive evidence to support our judgements, it also enhances our wider fundamental assessment of the credit profile.
Indeed, some of our most fruitful company meetings have been through an ESG lens – talking to company representatives, who while sometimes not necessarily as polished as board management, can provide greater insights into the overall risk management culture at the organisation, including company-specific ESG risks.

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Scoring

Our ESG Risk Rating Framework has a proprietary numerical scoring system used to help substantiate overall ESG risk ratings assigned to issuers. This assignment is based on the analyst's experience and relevant company-specific knowledge. A 'high impact' and 'short-term' ESG risk assessment results in a significantly more negative score. A 'low impact' and 'long-term' ESG risk results in a lower (negative) score. Hence, a maximum negative score for the framework would imply high impact and short-term judgements for every single ESG risk.
Once an analyst has reviewed the environmental and social sector starting designations, implemented any overrides, and populated the governance risk section, the overall score for the company or issuer is compared to the maximum negative score (MNS) possible in the framework. If the score is 40% or less of MNS then this substantiates a "low" ESG risk rating. If the score is 70% or higher of MNS then this substantiates a "high" ESG risk rating. The 40-70% range would equate to a "medium" ESG risk rating.

To further enhance the quality of output, the scoring system assigns different weightings to the scores of individual ESG risks depending on the business sector. Sectors with very obvious environmental impacts (such as extractive industries) have a higher weight assigned to the environmental risks category. Likewise, those sectors with obvious social risks (e.g. gambling and gaming) have a higher weight for the social risks section. A more 'generic' corporate would have a 50:50 weighting assigned to environmental and social risks. However, in all cases governance risks accrue the highest weighting – just over 40% of the total score. As we continue to operate the framework and generate more data, it will be possible to refine not just these weightings, but also the levels/bands used to substantiate ESG risk ratings over time.
Furthermore, we will be able to back test the key segments of the framework (e.g. environment risks) to check whether the scoring mechanism can be improved. This ultimately will lead to an enhanced understanding of the overall credit profile of debt issuers and support better decision making for client portfolios.

Governance override

At the start of this paper, we acknowledged the many challenges to conducting insightful ESG analysis. While our ESG Risk Rating Framework provides granularity and supports systematic comparisons, it is worth bearing in mind that it naturally can never capture every possible scenario for all the ESG risks that could have a material impact on a company. As such, in a very small number of cases, credit analysts can override the output of the framework and allocate a different ESG risk rating to the one 'calculated'. The rationale for this needs to be documented and recorded (with the basis for this always challenged by credit committees). However, it is important to stress that while we designed the framework to support a granular analysis, the interpretation of each risk must have some flexibility built in. Of course, at the same time we are very much aware that to support insightful back-testing the framework generally needs to be used in a similar and repeatable way as far as possible.

However, there is one further area of override which is automatic rather than analyst-driven. If the governance score for any issuer is 75% or more of the MNS for just the governance component, then the overall ESG risk rating will be "high", irrespective of the environmental and social scores. The basis for this is linked to experience in the credit markets (historically, governance risks have been more likely to drive credit spreads than environmental or social risks). Essentially, the experience here is that very poorly governed companies will typically have poor reaction functions to all risks, including ESG risks. One specific reason why an issuer would exceed the 75% MNS score for governance (and hence receive an automatic 'high' ESG risk rating) is if they are assigned a 'health warning' by ASI's Corporate Governance & Stewardship team.

Conclusion

The above discussion has attempted to shed some light on the ASI methodology for assessing ESG risks for bond issuers through our proprietary ESG Risk Rating Framework. As shown, the practical application of this framework requires specific information and detailed analysis that leverages existing expertise and allows for more effective comparison. The importance of peer reviewing to challenge the judgements being made is also paramount. Assessment aims to be as company -specific as possible, dynamic and forward looking. And perhaps uniquely, our framework explicitly includes estimation of the timeframes over which ESG risks may have an impact.

All this enhances the fundamental analysis of credit analysts and ultimately can significantly influence the decision as to the sufficiency of compensation being offered (in terms of spreads/ yields) relative to all relevant risks. Furthermore, portfolio managers can access reports to consider all ESG risks inherent across a fund or benchmark, considering both impact and timeframe. This can then lead to further work to optimise investment risk analysis. For example, buy & maintain strategies typically invest for the longer term (ideally buying a bond and holding to maturity). If the portfolio for such a mandate had a significant proportion of high impact risks with short-term timeframes for some issuers, then appropriate mandate-specific portfolio adjustments may be warranted.

ASI's ESG Risk Rating Framework is an essential tool for all credit analysis work. The application and resulting output can have significant consequences with regards to how risky we judge a credit profile and correspondingly the level of compensation needed. Accordingly, analysis utilising the framework is now a core component of all our internal credit notes, with the ESG risk rating and analysis key insights featuring on the very first page of all reports. Furthermore, to stimulate peer review and detailed discussions on how ESG risks may impact credit profiles, we also contrast to ASI's in-house ESG team's scores – operational, governance and controversy-based.

The ASI ESG Risk Rating Framework is tailored to make credit-specific judgements and to provide ESG risk insights on a global basis. Most importantly, we think it will continue to support our constant drive for better investment analysis and decision-making on behalf of our clients.

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