PALGRAVE STUDIES IN IMPACT FINANCE

Sustainability Rating Agencies vs Credit Rating Agencies

The Battle to Serve the Mainstream Investor

Daniel Cash

palgrave
macmillan

Palgrave Studies in Impact Finance

Series Editor
Mario La Torre, Facoltà di Economia, Dept Management,
Sapienza University of Rome, Rome, Italy

The *Palgrave Studies in Impact Finance* series provides a valuable scientific 'hub' for researchers, professionals and policy makers involved in Impact finance and related topics. It includes studies in the social, political, environmental and ethical impact of finance, exploring all aspects of impact finance and socially responsible investment, including policy issues, financial instruments, markets and clients, standards, regulations and financial management, with a particular focus on impact investments and microfinance.

Titles feature the most recent empirical analysis with a theoretical approach, including up to date and innovative studies that cover issues which impact finance and society globally.

More information about this series at
http://www.palgrave.com/gp/series/14621

Daniel Cash

Sustainability Rating Agencies vs Credit Rating Agencies

The Battle to Serve the Mainstream Investor

palgrave
macmillan

Daniel Cash
Aston University
Birmingham, UK

ISSN 2662-5105 ISSN 2662-5113 (electronic)
Palgrave Studies in Impact Finance
ISBN 978-3-030-71692-9 ISBN 978-3-030-71693-6 (eBook)
https://doi.org/10.1007/978-3-030-71693-6

Cover credit: Henrik Sorensen

This Palgrave Macmillan imprint is published by the registered company Springer Nature Switzerland AG
The registered company address is: Gewerbestrasse 11, 6330 Cham, Switzerland

Contents

CHAPTER 1

Introduction

In reading the title of this book, you would be forgiven for thinking 'what battle?' The ESG rating agencies, and the credit rating agencies, are two different industries. Though colloquially adjoined by the concept of *rating*, they serve two different purposes. The credit rating agencies serve to assess the creditworthiness of an entity and if ESG issues are of *material* relevance, then they should be considering those issues as well as financial issues. The ESG rating agencies exist to consider the sustainability of an entity, and then rate/rank it accordingly. In the light of the potential 'mainstreamisation' of the sustainable investor movement, there is increasing business being sent the way of the ESG rating agencies. However, there have since been a number of research endeavours that have identified key flaws in the delivery of those ESG-related ratings, which is calling into question the suitability of those agencies to meet this new demand.

The notion of a 'battle' between these two industries to serve this new mainstream investor base is not widely considered, but it has been identified. An interesting article in the *Financial Times* in 2019, entitled 'credit rating agencies join battle for ESG supremacy' suggested that:

> A flurry of dealmaking has begun among firms that provide companies with environmental, social and governance ratings, fed by increasing demand for the data among investors and regulators. The sector has traditionally been dominated by index providers such as MSCI and a handful of specialist

D. Cash, *Sustainability Rating Agencies vs Credit Rating Agencies*, Palgrave Studies in Impact Finance,
https://doi.org/10.1007/978-3-030-71693-6_1

> firms, such as Sustainalytics. Now Moody's and S&P Global, two of the big three credit rating agencies, are elbowing their way in, offering separate ESG scores on companies in addition to their traditional assessments of creditworthiness.[1]

The article continued by discussing how the market for ESG information is growing all the time, and that the credit rating agencies are well aware of this. Whilst a number of aspects would need to be added to the credit rating agencies' offerings, it was very much suggested that the two industries would come into contact at some point for the lucrative rewards that awaited them for adjoining to the movement of sustainable investment.

It is always wise to write a book like this, as if the reader is uninitiated with the world of credit ratings, because it is a somewhat niche element of the financial sector even though its impact came to light massively in the Financial Crisis. Nevertheless, this article in the FT made me wonder of what may affect that battle, and how it would play out—that is what this book is built on. In order to examine these questions further, we shall embark upon a journey that considers the development of the 'mainstreamisation' of the concept of sustainable investment, the histories and trajectories of the two industries, the underlying dynamics of the rating relationship, and then after reviewing the regulatory developments in the area of non-financial informational disclosure, we shall conclude with an assessment of who is likely to win this 'battle' that has been predicted.

The mainstreamisation of the concept of investing in a responsible and sustainable way is well under way. It is a direct response to the Financial Crisis and the actions of market participants who prioritised short-termism and an apparently blind faith in third-party verifiers of credit risk. The movement aims to force investors to consider elements of ESG—Environmental, Social, and Governance factors—into their decision making, which has the hope of forcing issuers to rise to the challenge also attached to it. The movement has been progressing, but is hitting snags along the way not that the leading investors are starting to turn their attention to it. On significant snag is the flow of information. From the issuers, investors want higher quality information. From the third-parties like ESG rating agencies and credit rating agencies, the investors want that higher quality information to be as standardised as possible, so that performance over industries and regions can be compared. As we shall see, there have been a number of initiatives developed that want to bring these requests to fruition, but they are also finding significant problems along the way. Now, with the E.U. and the U.S. taking very different approaches, there is even more divergence on the global scene and divergence is precisely what the investors do not want.

To assist with these issues, the ESG rating agencies and credit rating agencies are being challenged by a variety of initiatives to step up and provide solutions. Global initiatives like the Principles for Responsible Investment (PRI) have aligned themselves with the credit rating agencies to encourage them to a. increase their dialogue with investors and then b. provide more of what the investors require. This is underway and as we shall see in Chapter 3, the credit rating agencies are purposively and decisively turning their attention towards this nascent but potentially lucrative market. For the ESG rating agencies, their relatively younger market is attempting to cope with the pressures that come with serving the mainstream, and it is running into difficulties. How they handle the pressure that is building in the market for them will fundamentally determine the future of their industry, because the presence of much bigger market players suggests that if they do not get it right, their industry will not survive to tell the story. Therefore, in Chapter 2, we shall look at the industry, clear up some terminological problems in the literature, and then seek to understand better the chances of the industry overcoming the difficulties that have been identified.

In Chapter 4, we shall embark upon a really deep excavation of the 'rating dynamic' as I call it. Whether in relation to the ESG rating agency dynamic or the credit rating dynamic, there are fundamental truths that affect the balance between the parties and to have a hope of predicting who may prevail out of this prophesied battle it is important to know how that dynamic works. There are key elements, such as the need to 'signal', reduce competitive pressures, and extract the benefits from an oligopolistic model that need to be considered, and we shall do that. This leads us to the final chapter which will first present the regulatory and cultural developments in both the U.S. and the E.U. These two entities have been chosen because one is the home of the majority of these rating entities, and the other is attempting to lead the world in issues of sustainability and also disclosure. Other entities are worth mentioning of course, like China, but their relationships with the credit rating entities are much newer, less developed, and impacted by a whole host of different issues (like political models, etc.) Once that is established, we shall consider some private initiatives before then concluding with analysing some potential scenarios that may take effect, and then decide which is the more likely to come to pass.

The ESG rating agencies are under pressure, and the credit rating agencies are joyfully adding to it. The rewards for aligning oneself to this market could be momentous, and the market knows it. The trajectory of the two industries has been stark recently, with the ESG rating agencies needing to defend their practices and the potential of forthcoming regulatory frameworks for the first time in their history, whilst the credit rating agencies have consolidated since the Crisis and are going 'full steam ahead' towards this new and exciting marketplace for them. However, they themselves are constrained, and these constraints are constantly on the mind of the rating agencies, i.e. liability. The credit rating agencies are acutely aware of *any* potential liability that they are exposed to, and that fear is real in this new market given that they will have to espouse their opinion more than they usually do. But, for the ESG rating agencies, the prospect of the market or a region cracking the code on either a. increasing the informational flow in the market, or better still b. standardising the disclosure of that information, provide it with a glimmer of hope that they can develop their own credit rating industry-like trajectory and become powerhouses themselves. The next few years will really bring these two contrasting developments into focus and, potentially, into conflict. What we need to do is consider how that may look, why it will be, and what the outcome may be.

Note

1. Billy Nauman, 'Credit Rating Agencies Join Battle for ESG Supremacy' (2019) *Financial Times* (Sept 17). https://www.ft.com/content/59f60306-d671-11e9-8367-807ebd53ab77 (accessed 04/01/2021).

CHAPTER 2

The 'Mainstreaming' of Responsible Investment

The Financial Crisis, an event which defined the lives of so many, is righty seen as an incredibly negative moment in recent history. Livelihoods were ruined, economies crashed, and large swathes of society have been living with the financial repercussions ever since. Furthermore, the era was to become a seedbed for a political revolution that saw Donald Trump elected to the Office of President of the U.S., whilst on the other side of the Atlantic Ocean the British electorate decided to leave the European Union. Infighting within the E.U. sprouted in the wake of the upheaval, with populist governments springing up in places like Hungary. Now, the E.U. is pursuing a less-is-more approach as the bloc enters unchartered territory with its authority on the line. In the East, China continues to flex its political muscles in the region, backed by an ever-growing economy and an expansive foreign policy that has seen the Belt-and-Road initiative continue to grow. Political hot potatoes like the governance of Hong Kong have been handled in an authoritarian manner, all amidst a global trade war with the U.S. In the U.S., the country has been gripped by social upheaval in the wake of a number of high-profile killings of black men and women at the hands of police. Then, almost a century after the outbreak of the so-called Spanish Flu, the world has been engulfed by the COVID-19 'Coronavirus'. This virus has led to the world, essentially, being 'locked down' with the consequence being that economic, political, and overarching social divisions and problems have become heightened

D. Cash, *Sustainability Rating Agencies vs Credit Rating Agencies*, Palgrave Studies in Impact Finance,
https://doi.org/10.1007/978-3-030-71693-6_2

for all to see. However, the Financial Crisis did initiate a movement that has continued at a rapid pace and is beginning to impact upon the 'mainstream' financial arena; that movement was to make modern finance more 'responsible'.

Making modern finance more 'responsible' arguably makes sense in the wake of what I have described above. Seeking to make modern finance consider more than just the potential financial return from their actions, or seeking to expand the time horizons that are considered in financial circles, simply makes a lot of sense when we consider what caused the Financial Crisis. However, and unsurprisingly, things are not that simple. When I say 'financial arena', what do I mean? Are there particular targets for this movement, or is the aim to change the wider *culture*? When I say that an aim is to increase the time horizons which are considered, then how long should one aim for? How long is *material* for effective decisions to be made for financial entities? If the aim is to make modern finance consider more than just the potential return, then what should they consider? Should said considerations be externally mandated, or should financial entities be allowed to develop their own understanding of what should be considered? Would allowing financial entities to choose, be the most efficient approach, and would those entities even want that freedom? As you can clearly see, this issue is extraordinarily complex. Even more so, what if the *aim* was not even agreed upon! What if we did not even have a standardised definition for the movement we want to develop? Unfortunately, this is absolutely the case. As it is not my intention to contribute to that complexity, I would like to digress for a moment and look at the importance of clarifying, definitionally, what we are looking at in this book.

2.1 Definitional Complexity and the Origins of the Movement

The history of investing for a reason other than purely for financial gain is a long and storied one. We will look more at this history in the next subsection, but there are a few definitions that get used in the literature and wider financial arena that may confuse. For example, there appears to be a consistent and common interconnecting usage of the terms 'Socially Responsible Investment' and 'Responsible Investment'. Furthermore, there are many occasions were 'sustainable finance' is used, and then occasions were 'responsible finance' is used to describe the *movement* we are concerned with in this book. There are a variety of reasons for this and, for better or worse, this issue is probably emblematic of the anchor that is holding the movement back (relatively speaking). Krosinsky and Robins explain this neatly when they say that:

> …it's necessary to provide some guidance on the terminology used in this book. Over the past 30 years, a range of terms, notably "social", "ethical", "green", "responsible", "socially responsible" and "sustainable", have been used to describe the merging practice of incorporating extra-financial factors within investment decision-making. One woman's "ethical investing" is another man's "socially responsible investing", and one firm's "responsible investing" is another manager's "sustainable investing". On reflection, this embarrassment of semantic richness is perhaps understandable for a rapidly evolving approach, where the final form has yet to be settled. In such a fluid field, we are all well aware of the dangers of false precision.[1]

Ballestero et al. discuss how 'SRI, also known as ethical investing, responsible investing, green investing, impact investing or sustainable investing, shares with conventional investing the top priority given to financial profitability, while considering in additional social, ethical or environmental parameters'.[2] Yet, Hebb tells us that 'responsible investing has always had a broad mandate. Put simply, it is a long-term sustainable investment strategy that values environmental, social, and governance factors in the public equities portfolios of investors concerned with the long term risks that ESG considerations may pose'.[3] One includes the 'S' of 'socially', whilst one drops it; but is this important? Cullis et al. state that:

> The terms *ethical* and *socially responsible* (and, more commonly nowadays, *sustainable*) are labels regularly attached to a range of enterprises; it is important to ask what these terms mean (besides indicating that the activity is generally a good thing). *Social Responsibility* is the favoured term… there more troublesome label of *ethical* having been dropped. But could this legitimisation of SRI as part of "third way" politics lead to a watering down of the ethical brew? CSR has formed a broad agenda where businesses are asked to improve their social, environmental, and local economic impact and consider how businesses affect society at large in terms of human rights, social cohesion, fair trade, and corruption. If anything, the notion of sustainability is even more vague and ell-embracing.[4]

The authors continue by stating that 'it seems that the popularity of what we might now best refer to as SRI (the internationally most favoured label) is set to continue to rise, given its increased visibility to institutional investors and because around 70 percent of individual investors feel they ought to be investing ethically even if they are not doing so at present'.[5] It is tempting to agree with them, that SRI is the most favoured label, but there is no definitive evidence for this. Actually, I would argue that *Responsible Investment* is the most agreed-upon term, solely because of the popularity and the acceptance of the PRI, otherwise known as the *Principles for Responsible Investment*, which is a UN-backed global initiative that has over 1000 of the world's leading investors and financial entities as partners (we shall be introduced to the PRI in much more detail shortly). Yet, as ever, there are major issues with these definitions so far. One is that the PRI, in spite of their primacy, have been criticised for being a 'misleading indicator' because 'the reality is that PRI signatories commit only to behaving in accordance with a set of principles for responsible investment, a commitment that falls well short of integrating ESG considerations into all of their investment decisions'.[6] The second issue is an issue I have with the focus of the definitions of socially responsible investment, or responsible investment, is that it is merely focused on the actions of the investor. Whilst it is absolutely understandable that the investor has been identified as being the lynchpin in the development of the movement (which I agree with), the definition does not take into account, directly, the role of those investors invest in. Perhaps I am splitting hairs and that, in reality, the act of the investor taking a 'responsible approach' to their investing, i.e. considering more than just financial performance, and/or a longer time-horizon, has the effect of forcing the issuer to alter their processes as well. I digress. Potentially, on that basis, it may be more appropriate to talk of 'sustainable finance' because, as Miles describes:

> Although there is no comprehensive definition, the concept of sustainable finance encompasses the lending and investment activities of private equity financiers and institutional investors, as well as entities from the public sector such as the World Bank and multilateral development banks. At its broadest, sustainable finance refers to the "mainstreaming of environmental and socio-economic criteria into lending, investment and other financial services". The NGO community tends to interpret it as requiring more

innate changes in approach, such as deep-rooted commitment to social and environmental responsibility, transparency, accountability, and precaution.[7]

Rather than complicate the issue any further, it may be best to focus on the broader objective of the movement, whether funnelled through the investor or not, and Robins gives us a clear definition upon which we can build when he says that 'part of the essence of contemporary sustainable investing is the realisation that investors need to understand, measure, and promote superior financial *and* non-financial performance'.[8]

Just a moment ago, we saw the criticism of the PRI in that it does not force its signatories to *integrate* a concept known as 'ESG' more into their financial processes, but what does that all mean? 'ESG' stands for environment, social, and governance and relates to aspects that should be considered when decided on, say, investment opportunities. Examples may include the impact a business has upon the climate (for the 'E'), the business' position with regard to modern slavery, or its record on employee-related issues (for the 'S'), or the strength and consistency of its Board and internal management structure (for the 'G'). However, we can see an issue in my describing of 'ESG', because for the 'S' I mentioned the imagined business' approach to modern slavery; what if there are (and there predominantly are in the developed world) strict regulations governing the exploitation of people? Abiding by those rules, and making sure the company proactively and efficiently declares such adherence, may fall under the 'G'overnance aspect too. The variety and multiplicity of the world and everything in it mean that ESG, as a concept, is a really good starting point but, in reality, it needs to be contextualised and understood on a variety of levels, all the time.

Nevertheless, even if that definitional complexity is somehow resolved, how the concept of ESG came to be, and how it is applied, simply continues the complexity. Let us start with a simple question. So far, we have seen many explanations and definitions of the *movement* of encouraging financial players to think about and, moreover, start to act upon the premise that one can participate in the market and think of something else other than financial return. We have also seen that the emphasis has been placed upon the 'investor'. However, who *is* this investor? What is their position? Understanding this means we *may* be able to ascertain what they want from the interaction and, perhaps more crucially, what they can *do*. To deviate for one moment, in the wake of the Wall Street Crash of 1929 and the subsequent Great Depression, the focus was on