Principles for Responsible Investment

European Leveraged Finance Association

ESG IN CREDIT RISK AND RATINGS: BRINGING ANALYSTS AND ISSUERS TOGETHER

Sub-investment Grade Borrower Workshop - Part 2a

The ESG in Credit Risk and Ratings Initiative is funded by the Gordon and Betty Moore Foundation through the Finance Hub, which was created to advance sustainable finance.

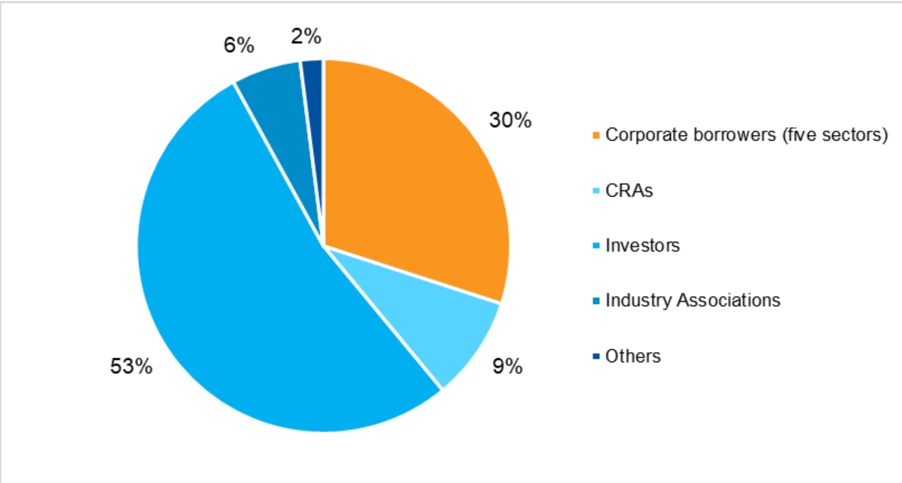
NOTES FROM THE WORKSHOP

The PRI's ESG in credit risk and ratings initiative is, for the first time, bringing voices from the corporate side into the conversation on how to better integrate environmental, social and governance (ESG) factors into credit risk analysis. This article summarises the key points from a workshop held with sub-investment grade (IG) borrowers, bringing together buy-side and sell-side credit analysts, representatives of credit rating agencies (CRAs), corporate finance and investor relations teams. This workshop, held in collaboration with the European Leveraged Finance Association (ELFA), is the sixth of the series Bringing credit analysts and issuers together, as part of the ESG in credit risk and ratings initiative, which promotes a transparent and systematic consideration of ESG factors in credit risk assessment.[1]

The 28 January 2021 workshop was hosted in collaboration with the ELFA, reflecting synergies between the PRI's ESG in credit risk and ratings initiative and the ELFA's ESG disclosure initiative.[2] The event was the second organised with the ELFA with sub-IG corporate borrowers and attracted over 100 market participants, including representatives from 20 corporates from five different sectors: chemicals, industrials, retail, technology and software, and communications infrastructure. Six CRAs and 51 investors from 32 organisations were also in attendance (see Figure 1 and Appendix for the full list of participating organisations).

The discussions were held under the Chatham House Rule and were structured around a set of guidelines that were circulated to participants prior to the event and tailored by sector.[3] After the 2020 workshops, the PRI and the ELFA have published sector-specific ESG Fact Sheets and will add to the list over the coming months. These are designed to support borrowers in preparing ESG disclosure, and to facilitate engagement between investors and corporate borrowers on important ESG topics.

Figure 1: Event participants by type



[1] The workshops series follows a string of 21 roundtables organised for institutional investors' credit analysts and CRA representatives between 2017 and 2019. The discussions are documented in the trilogy, Shifting perceptions: ESG, credit risk and ratings.
[2] The ELFA is joined in this initiative by the Loan Market Association (LMA).
[3] The PRI initially published these guidelines after the Paris workshop, the first of the series. They will be refined as the workshops continue.

This report contains highlights from discussions held during the breakout sessions with companies in the retail, technology and software, and communications infrastructure sectors. These sessions were held at the same time as others focused on the chemical and industrial sectors, which are summarised in [Part 2b] of this article. Some observations were common or were covered in other articles of the series. In this report we address only new or sector-specific themes, and report on emerging solutions that participants have begun to consider.

Key findings of these discussions are grouped into four main areas, as follows:

1. Efforts to improve ESG disclosure;
2. A growing focus on diversity and inclusion;
3. Analysing supply chain risk; and
4. Safeguarding consumer privacy and data security

1. EFFORTS TO IMPROVE ESG DISCLOSURE

There was a consensus amongst participants that standardising the disclosure of ESG information will benefit both investors and borrowers. Currently, borrowers receive numerous different ESG questionnaires from investors, typically at the time of marketing a new transaction, which require significant resources from borrowers and their advisers. For this reason, borrowers support efforts to identify alternative ways of communicating ESG information and welcome the development of the ESG Fact Sheets.

> “We held a series of investor calls before Christmas, and 50% of them focused on ESG.” – Corporate borrower

Although ESG disclosure is at an early stage, there are positive signs. Investors noted that ESG data disclosure by corporate borrowers is improving. At the same time, borrowers are now able to describe the processes they have developed to improve disclosure on ESG topics. For example, one participating company now includes ESG information in deal marketing materials. This inclusion can strengthen a borrower’s profile and have a positive impact on the business. Another corporate borrower acknowledged that both financial prudence and fair customer treatment contribute to how consumers view them. It also acknowledged that increasing ESG disclosure can have a positive impact on the company’s bottom line: bolstering brand value, attracting new customers or retaining existing ones, whilst minimising litigation and reputational risk can clearly have a positive impact on revenues.

> “ESG topics used to be largely background noise until 2019, since then [discussion on these topics has] exploded.” – Corporate borrower

Substantial challenges remain, however, before ESG reporting can be standardised within and between sectors. According to one CRA participant, it can be difficult to find a single set of metrics that can be broadly applied for a particular industry when there is significant segmentation in respective business models. Nonetheless, participants agreed that some level of standardisation in ESG requests from investors would facilitate reporting by the companies and the analysis by credit analysts, which is the objective of the sector-specific ESG Fact Sheets that the PRI and the ELFA are producing.

> “The ESG Fact Sheets are a great step towards establishing standards.” – Investor participant

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Inclusion of ESG information in deal offering materials and ongoing corporate reporting, using the PRI-ELFA sector-specific ESG Fact Sheets as starting point.

2. GROWING FOCUS ON DIVERSITY AND INCLUSION

Diversity and inclusion topics featured prominently in discussions during the event. Some corporate borrowers noted that attracting and retaining talent, together with achieving diversity and inclusion within their workforce, was a high priority. This was particularly the case for the technology and software breakout session as employees are a key asset in this sector and competition for talent is high. Borrowers also reported that it was becoming a more frequent topic of discussion with various stakeholders over the last year.

Participants highlighted several regional differences. The focus in Europe is currently on achieving gender diversity, whereas in the US discussions are more centred on racial diversity. Furthermore, there are practical challenges in Europe in collecting diversity data from employees, as European privacy laws restrict the processing of sensitive categories of data, including race, ethnicity, political opinions, religious or philosophical beliefs, and sexual orientation.

Borrowers were generally supportive of disclosing diversity metrics. Some common diversity data is already available, and investors reported being interested in monitoring progress in this area. Participants noted that while diversity within a workforce is easier to measure, inclusion – the process of creating a workplace culture that allows all employees to thrive – is more difficult to quantify. It relies on qualitative assessments of corporate culture, and the related perceptions of employees.

Participants also discussed setting diversity targets and measuring progress towards those targets. Borrowers use different targets, with some set at the board level and others at senior management level. In addition to having diversity and inclusion programmes, one investor participant noted that it is equally important to have a process in place to measure the effectiveness of these programmes over time. Another investor highlighted that gender pay-gap information is useful information.

“Inclusion is more complex. It’s a feeling to some extent, harder to measure, comes down to culture. Are you giving employees a forum to express [themselves]?” – Corporate borrower

EMERGING SOLUTIONS

Setting and disclosing diversity targets; measuring and monitoring progress towards them. Disclosure and measurement about inclusion is harder because it relates more to a company culture. It was suggested that the number of hours of employee training on this topic could be a useful key performance indicator, as well as having a senior company official at the board level responsible for overseeing this aspect, in addition to the human resources department.

3. ANALYSING SUPPLY CHAIN RISK

Supply chain risk is an important area for investors, as they seek to evaluate how a corporate borrower manages its exposure to other parts of the production process - in particular how working standards of suppliers are monitored. This can have a significant impact on the bottom line – for example, labour unrest can result in production delays, reduced productivity and product quality, as well as causing reputational damage for the borrower.

Investors reported that they do not currently have sufficient information to assess a borrower’s management of supply chain risks, including whether human and labour rights are upheld across all of its parts.

This is a challenge for corporates as there can be numerous third parties involved. One borrower pointed out that it is difficult to fully understand the working conditions across the supply chain, and that this requires extensive due diligence.

“We are aware of working conditions in manufacturing locations in high-risk countries and we now have a set of selection criteria in place for [those manufacturers].” – Corporate borrower

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Introducing supplier codes of conduct emerged as a partial solution to this challenge. Some borrowers already do require third parties and suppliers to sign up to their codes. Such codes of conduct should cover the prevention of forced/child labour, the setting of minimum wages, and the provision of health and safety for workers.

4. SAFEGUARDING CONSUMER PRIVACY AND DATA SECURITY

As in the September 2020 workshop, privacy and data security was again a key topic. Data breaches may result in loss of revenues and unexpected costs from remediation and litigation. They can also lead to negative headlines and reputational damage for the company. As such, investors and CRAs seek to assess how borrowers are managing cybersecurity risks and the protection of consumer data, inquiring into the systems and processes that are in place to protect personal data as well as seeking information on data breaches or other privacy-related controversies.

For retail companies, the COVID-19 pandemic has resulted in a further rise in the importance of e-commerce. At the same time, it is also serving up new challenges, such as dealing with consumer data in compliance with local regulations, and preventing cybersecurity attacks.

In the software sector, investors and borrowers agreed that data security and privacy, including ransomware attacks, are key ESG risks. It is of paramount importance for investors to understand how personal data is stored, used and protected.

It can be challenging to quantify these issues or find specific metrics, according to one corporate borrower. An investor noted that while data security threats and breaches are inevitable, they seek to understand how prepared borrowers are to face future threats. A credit analyst might ask how and where data is stored, but also whether a borrower has analysed the risks associated with these decisions. In addition, investors may ask questions about what certifications are held – for example, the International Organization for Standardization (ISO) certifications on the quality, safety, and efficiency of products, services and systems. Investors may inquire about third party audits too. The borrowers at the event did not see any material challenges in providing this information.

Investors noted that it was difficult to quantify risks using metrics in this area - one serious attack may do substantially more damage than several minor breaches. Equally, one investor noted that a borrower's defences may have become more robust since a previous breach, so the number of previous breaches was not necessarily a good measure of risk.

Participants also discussed the challenges of complying with General Data Protection Regulation (GDPR) in Europe. One corporate borrower said that compliance with GDPR through policy documents was important to them and they were comfortable in providing relevant information to investors, including what data is stored and how it is used.

“We’ve seen a rise in investor ESG requests, and we are trying to meet these requirements and develop our policy handbook.” – Corporate borrower

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Increase disclosure on borrowers' cybersecurity policies and their approach to disclosing breaches. Information on third-party investigations, external certifications and staff training processes is helpful to guide this analysis.

5. SECTOR-SPECIFIC CONSIDERATIONS

The discussions highlighted several other considerations specific, but not unique, to the industries of the companies represented. The following are examples of areas where investors may request more information for ESG analysis, and where borrowers may seek to improve disclosure.

COMMUNICATIONS INFRASTRUCTURE	RETAIL
■ Electricity consumption ■ Electromagnetic emissions and their impact on public health ■ Maintenance of tower sites to minimise physical damage to surroundings, e.g. wildlife, wildfires ■ Clear financial policy on acquisitions and leverage ■ Board independence to ensure equal access to infrastructure	■ Labour standards across the supply chain, e.g. disclosed according to International Labour Organization standards and the Fair Labour Association Code of Conduct ■ Product safety and raw materials ■ Product packaging ■ Risk associated with e-commerce and cybersecurity
TECHNOLOGY/SOFTWARE ■ Employee satisfaction levels, e.g. through employee Net Promoter Scores (eNPS) ■ Number of hours of training to prevent cybersecurity attacks ■ Handling of customer complaints, and the challenges of disclosing information about these complaints ■ Disclosure of how technology/software helps companies to achieve their carbon ambitions (since carbon footprint is a less relevant metric than in other sectors)	

Keep up-to-date with the PRI's ESG in credit risk and ratings initiative and ELFA's ESG disclosure initiative

APPENDIX

Table 1: Participating organisations

Sector	Companies
Chemical	Ineos, Synthomer, Nouryon, SNF, OCI, IGM Resins, Röhm
Communications infrastructure	Cellnex
Industrial	TK Elevator, Loxam Rental, Groupe Delachaux, Leonardo SpA
Retail	Amer Sports, Maxeda, EG Group
Technology and software	Almaviva, Anaqua, ION, ERT, Exact
Investment institutions	
Alcentra	CVC
Apollo	Fiera Capital
Astorg	Hermes Investment
Bain Capital	KKR
Barclays	M&G
Bardin Hill Loan Advisors	Man Group
Barings	Morgan Stanley IM
Bayerische Versogungkammer	Muzinich
Blackstone	Newton IM
BlueBay Asset Management	NinetyOne
BNP Paribas AM	Oaktree
Brown Advisory	PGIM

Cairn Capital	QBE
CDPQ	Rothschild & Co
CIFC AM	Tikehau Capital
Columbia Threadneedle	Voya AM
CRAs	
Fitch Ratings	Qivalio
Kroll Bond Rating Agency	Scope Ratings
Moody’s Investors Service	S&P Global Ratings
Other industry associations	
Loan Market Association	Loan Syndications and Trading Association