Credit Spotlight: Environmental, Social and Governance Considerations and Issuer Credit Ratings

GCR's ratings factor in a myriad of environmental, social and governance (ESG) considerations into issuer credit ratings. The below highlights the key considerations, broken down by criteria/sector/factors. Overall, GCR believes that ESG considerations can interact with the GCR ratings criteria, and therefore ultimately to the GCR issuer ratings, in five major ways.

1. ESG can change the country risk and sector risks scores, which act as an anchor to the GCR Risk Score and determine the hurdle/support level.
2. ESG can change the entity specific fundamentals of any issuer, separating it from peers either positively or negatively, in the competitive position assessment.
3. The management and governance assessment is exclusively focused on management quality and governance matters, including adherence to social contracts and the regulations (whether it be environmental, legal or social).
4. GCR's considerations regarding leverage or funding can be positively impacted by the presence of longer-term stable 'ESG' funding lines.
5. The level of group support or government support can differ depending on the mandate and success in regards to ESG.

For purpose of clarity, GCR use the following definitions for ESG:

- **Environmental:** includes an entity's use of renewable energy sources, waste management program, raw material sourcing, handling of potential problems of air or water pollution arising from its operations.
- **Social:** includes the company's relationship with its employees, customers, and communities (stakeholder engagement and impact).
- **Governance:** refers to how the company is managed by its executives and full and honest financial reporting.

Factors	Criteria	Applicable	Environmental	Social	Governance
Country Risk	Criteria for the GCR Ratings Framework, Country Risk section from page 9.	All Issuer Credit Ratings	The Country Risk Score analyses and will negative adjust for commodity concentrations and other environmental risks under the Economic Risk Score and adjustments.	GCRs core part of the economic strength score, is the GDP per capita, which measure average wealth levels of a population. GCR also use the World Economic Forum Competitive Index (WEFCI), as a core part of the Institutional Score. The WEFCI measures countries using some human capital measures, including health and skills of a population. Weaker scores will lead to lower ratings all else being equal.	GCR use the World Bank Governance Indictors (WBGI) as a core part of the Institutional Score. The WBGI rank countries according to various governance factors. These factors include regulatory quality, rule of law, control of corruption, political stability and absence of violence, voice and accountability, and government effectiveness. Weaker scores will lead to lower ratings all else being equal.
Management & Governance Criteria	Criteria for the GCR Ratings Framework, Management & Governance Criteria page 26.	All Issuer Credit Ratings	If there are regulatory risks, reputational risks or other significant environmental exposures we can lower the Management & Governance score. For example if a corporate is using unsound environmental practices that have drawn attention of media, regulators, and investors the Management & Governance score may be lowered.	If there are regulatory risks, reputational risks or significant social (staff, customers, or communities) exposures we can lower the score. For example, an entity whose products causes some social harm, which has attracted negative attention of the regulators, media, or investors. Repeat fines for not treating customers fairly could also be a good example.	The Management & Governance Criteria focuses on the Governance of all rated entities and issues. There is a significant breakdown of all the factors GCR looks at in the criteria.
Group Support	Criteria for the GCR Ratings Framework, page 22.	All Issuer Credit Ratings when the rated entity is part of a group	If an entity has not performed in line with wider group expectations on its environmental mandate/ promises, GCR could lower group support as it could demonstrate lower group controls or a reputation barrier to ongoing support. Conversely, if the entity is responsible for a large amount of the wider groups environmental strategy, we could improve the scores.	If an entity has not performed in line with wider group expectations on its social mandate/promises GCR could lower group support as it could demonstrate lower group controls or a reputation barrier to ongoing support. Conversely, if the entity is responsible for a large amount of the wider groups social strategy we could improve the scores.	Weak management and governance within a rating entity could lower group support uplift, as it may demonstrate weak group linkages and operational integration, or present a reputational barrier to ongoing support.

Factors	Criteria	Applicable	Environmental	Social	Governance
Financial Institutions	Criteria for Rating Financial Institutions	Banks and non-bank financial institutions issuer credit ratings	GCR factor in ESG into the competitive position and funding/ liquidity. As we believe strong ESG fundamentals can improve the franchise of a financial institutions and provide greater access to stable funding. An example of this would be when the financial institution has an explicitly social or green mandate, success of which is demonstrated by the loan or equity investment book, or when a significant percentage of funds originate from social or green funds. This is particular true when analysing Development Banks. Evidence of relatively weaker / reputationally damaging ESG practices, could bring down the competitive position assessment.		Governance and transparency are a key factor in the country & sector risk score. Management & Governance is a key factor within the business profile component.
Financial Services Criteria	Criteria for Rating Financial Services	Financial services entity issuer credit ratings	GCR view FSCs much in the same way as we look at Financial Institutions. However, typically such entitles are smaller and have a more focused strategy/mandate. Any green or social mandates will be included in the competitive position, if we consider it to be an advantage/niche. We would also positively view mandated social/green funding. Conversely, if the entity is involved in any relatively unsound environmental or social practices, we could lower score.		
Asset Management Ratings	Criteria for Rating Asset Managers	Asset Managers	Asset Managers are increasingly driven by ESG considerations, as investors are more focused on the ethical returns. Should an asset manager be able to demonstrate a mandate, or stronger track-record of ESG investing than market peers or completive positioning due to the ESG consideration we could uplift the competitive position assessment.		
Supranational Criteria	Criteria for Rating Supranational Institutions Criteria	Supranational Entities, typically banks and insurers.	As inherently mandated institutions, ESG considerations play a significant role in the ratings of Supranational Institutions. Specifically, within the business profile, GCR examine the mandate and track-record of successfully delivering against its own goals. Typically, these are infrastructural or trade led mandates within our core markets. When considering the assessment, a Supranational can only get positive scores if they have a positive developmental impact, with a track record of addressing the needs of member states. Furthermore, GCR will analyse the loan book and the funding book (premiums for supranational insurers) for evidence of a strong ESG focus, potentially lowering cores for Supranational that do not exhibit stronger than average characteristics versus local private sector banks/insurers.		Governance and transparency are a key factor in the country & sector risk score. Management & Governance is a key factor within the business profile component.
Fund Ratings	Criteria for Fund Ratings	Fund Ratings	Funds which significantly differentiate themselves from market peers, in regards to investments into environmentally or socially focused entities or bonds, may be uplifted in the weighted average credit quality assessment.		Management & Governance is a key part of the Management Assessment for each fund. Shortfalls in management structures, operations, governance or regulatory adherence could bring down the assessment and the ratings.

Factors	Criteria	Applicable	Environmental	Social	Governance
Insurance	Criteria for Rating Insurance Companies	Insurance and Reinsurance Companies	ESG can impact the GCR financial Strength Ratings on insurance companies in one of three ways. Firstly, for those institutions that have specific mandates such as covering social risks, rolling out micro-insurance or wider supranational mandates, GCR will examine the success in delivering against the stated mandate in the competitive position. Secondly, within the capitalisation assessment, GCR will examine underwriting/risk assessment processes, capital planning and reinsurance utilisation to see how (re)insurers are able to mitigate future losses from ESG risks. This is particularly true in the management of climate led catastrophe risks. Thirdly, GCR may also bring down the competitive position if we consider that (re)insurers are exposed to potential reputational risk if they exclude or limit coverage to policyholders.		Governance and transparency are a key factor in the country & sector risk score. Management & Governance is a key factor within the business profile component.
Medical Schemes	Criteria for Rating Insurance Companies, appendix South African Medical Schemes	Medical Schemes	Medical schemes are inherently focused on the membership base therefore the social element covers the quality of cover provided to members. This is inherently part of the competitive position for each medical scheme. At the moment, Environmental concerns appear to be secondary to social for the industry.		
Structured Finance	Criteria for Rating Structured Finance Transaction	Structured Finance Criteria	Not Applicable	Not Applicable	Legal and corporate independence of the special purpose vehicle is assessed, through governance structure and controls in place. Servicer operational review focuses on management experience, policies and controls. The outcome of the servicer operational review impacts the default probability assumption made for the structure.
Project Finance	Criteria for Rating Project Finance Transactions	Project Finance Entities	Environmentally sound projects and technologies (either for construction or operating phase) provide uplift for the project ratings, as do access to green funds. Furthermore, projects will be assessed for local community impact and involvement.		Legal and corporate independence of the SPV is assessed, through governance structure and controls in place. Project management operational review focuses on management experience, policies and controls.
Investment Holding Companies	Criteria for Rating Investment Holding Companies	Investment Holding Companies	All ESG factors on the investee companies are included in the business profile analysis. Furthermore, if the IHC has been designed on ESG principles it could positively impact the investment track-record.		Governance and transparency are a key factor in the country & sector risk score. Management & Governance a key part of the business profile.

Sectors	Criteria	Applicable	Environmental	Social	Governance
Corporates	Criteria for Rating Corporates	All non-financial corporate issuer credit ratings	Environmental factors are initially factored into the sector risk score via industry dynamics and then mitigated or accentuated through the competitive position (see below). We may also provide some uplift in the Leverage & Cash Flow assessment, if we see superior access to stable/low-cost 'green' funding.	Social factors are initially factored into the sector risk score via industry dynamics and then mitigated or accentuated through the competitive position (see below). We may also provide some uplift in the Leverage & Cash Flow assessment if we see superior access to stable/low cost- social' funding.	Governance and transparency are key factors in the industry dynamics part of the sector risk score. Management & Governance a key part of the business profile.
of which Primary Industries	Criteria for Rating Corporates	Mining, Oil & Gas, Agriculture	When rating companies within the primary industry bracket, the competitive position assessment will assess (but not exclusively) the environmental degradation versus rehabilitation, water usage, power supply and usage, and the types of raw product (environmentally hazardous or not) created by the entity against sector averages.	Social considerations such as employment conditions, safety, community impact, and mine/other licensing requirements are included in the competitive position assessment.	Alongside all of the other Management & Governance factors, GCR will look at the entity's compliance with specific environmental regulation and examine the transparency integrity of the tendering and contracting processes, as part of the governance assessment.
of which Secondary Industries	Criteria for Rating Corporates	Construction, Manufacturing and Utilities	When rating companies within the secondary industry bracket, the competitive position assessment will take into account environmental factors such as the entity's carbon footprint, adoption of green technologies, management of waste products, water usage, green-field v brown field, up- or recycling of materials, and any ad-hoc strengths and weaknesses against the sector averages assumed in the relevant sector risk score.	Social considerations, such as employment conditions, impact on communities, noise/visual pollution will also be assessed in the competitive position score against the perceived sector averages.	Management & Governance concerns will be broadly similar to other industries, but more focus on the tendering and contracting process, adherence to relevant regulations may be applicable and ensuring that appropriate licenses/permissions are received.
Of which Tertiary Industries	Criteria for Rating Corporates	Retail, Hospitality and Services	When rating companies operating predominantly in Tertiary sectors, GCR focuses on how the entity manages its carbon footprint, waste management, adoption of green technologies and recycling versus sector averages.	The social considerations include employment conditions but also broader considerations regarding the ethical considerations of the entity versus the industry.	Management & governance concerns are broadly the same as the core criteria, but may have more focus on customer protections and relevant industry regulations.

Sectors	Criteria	Applicable	Environmental	Social	Governance
Local & Regional Governments	Criteria for Rating Local & Regional Governments	All local and regional government issuer credit ratings	Not Applicable	The percentage of development expenditure versus the budget is considered in the operating performance score.	Governance and transparency are a key factor in the sector risk score adjustment to country risk. Management & Governance is a key part of the business profile.
REITs and Property	Criteria for Rating Real Estate Investment Companies and Other Property Companies	All REITS and property issuer credit ratings	Environmental concerns are considered in the property exposure, should it be a differentiator or secure better access to funding then the score could be positively impacted.	Properties that include social housing initiatives could aid the portfolio composition assessment, if it gives any advantages. Portfolios with a high percentage of green star rated buildings could also be a competitive advantage.	Governance and transparency are a key factor in the country & sector risk score. Management & Governance is a key part of the business profile.

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Related criteria and research

Criteria for the GCR Ratings Framework, May 2019
GCR Rating Scales, Symbols and Definitions, May 2019
Jurisdictional Supplement for Criteria, July 2020
Criteria for Fund Ratings, July 2020
Criteria for Rating Medical Schemes, May 2019
Criteria for Rating Financial Institutions, May 2019
Criteria for Rating Financial Services Companies, May 2019
Appendix to Criteria for Rating Financial Services Companies: Asset Management Issuer Credit Ratings,
Criteria for Rating Supranational Institutions, May 2019
Criteria for Rating Investment Holding Companies, Nov 2019
Criteria for Rating Insurance Companies, May 2019
FAQ to Criteria for Rating Insurance Companies, Nov 2019
Criteria for Rating Structured Finance Transactions, Sept 2018
Criteria for Rating Consumer Asset Backed Securities, Sept 2018
Criteria for Rating Trade Receivable Secuiritisations, Sept 2018
Criteria for Rating Residential Mortgage Backed Securities, Sept 2018
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Criteria for Rating Asset Backed Commercial Paper, Sept 2018
Criteria for Rating Credit Linked Notes and Repackaging Vehicles, Sept 2018
Criteria for Rating Collateralised Loan Obligation Transactions, Sept 2018
Criteria for Rating Project Finance Transactions, Sept 2018
Global Master Structured Finance Servicer Rating Criteria, Sept 2018
Criteria for Rating Servicer Quality, Sept 2018
Criteria for Rating Corporate Entities, May 2019
Criteria for Rating Real Estate Investment Trusts and Other Commercial Property Companies, May 2019
Criteria for Rating Local and Regional Governments, June 2019