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Environmental, Social and Governance:

How We Apply Our ESG Evaluation Analytical Approach

April 10, 2019

S&P Global Ratings' ESG Evaluation, which is not a rating and is distinct from any piece of its ratings criteria, reflects a burgeoning question in the investment community: how are environmental, social, and governance (ESG) factors captured in decision making and how do they affect an entity's capacity to operate successfully in the future? And, importantly, how could ESG factors potentially lead to a material direct or indirect financial impact on the entity?

While our credit ratings incorporate an analysis of ESG factors when they are material to credit quality, the ESG Evaluation offers a deeper analysis of ESG factors even if there is no direct impact on credit quality. An ESG Evaluation provides a cross-sector, relative analysis of an entity's capacity to operate successfully in the future and is grounded in how ESG factors could affect stakeholders and potentially lead to a material direct or indirect financial impact on the entity. Stakeholders can include equity investors, consumers, communities, employees, and regulators. We answered a range of questions that we've received from these various stakeholders about how we apply our "Environmental, Social, And Governance Evaluation Analytical Approach," published April 10, 2019.

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Frequently Asked Questions

Can other types of issuers (e.g. insurance companies, public finance entities, and financial institutions) be assessed under the ESG Evaluation analytical approach?

Yes. Our analytical approach has applicability beyond corporate entities and can currently assess comparable non-profit sectors including utilities and transportation-related entities. In the near term, we intend to make the ESG Evaluation product available to banks, asset managers, multilateral lending institutions, as well as other public finance enterprise sectors including hospitals, water, and sewer entities. We also believe the ESG Evaluation framework has applicability for insurance companies and the social housing and education sectors, and we will be exploring relevant data sets and expanding the product to these entities in the future. National, regional and local governments are not currently in the scope of ESG Evaluations.

How does the ESG Evaluation differ from credit ratings?

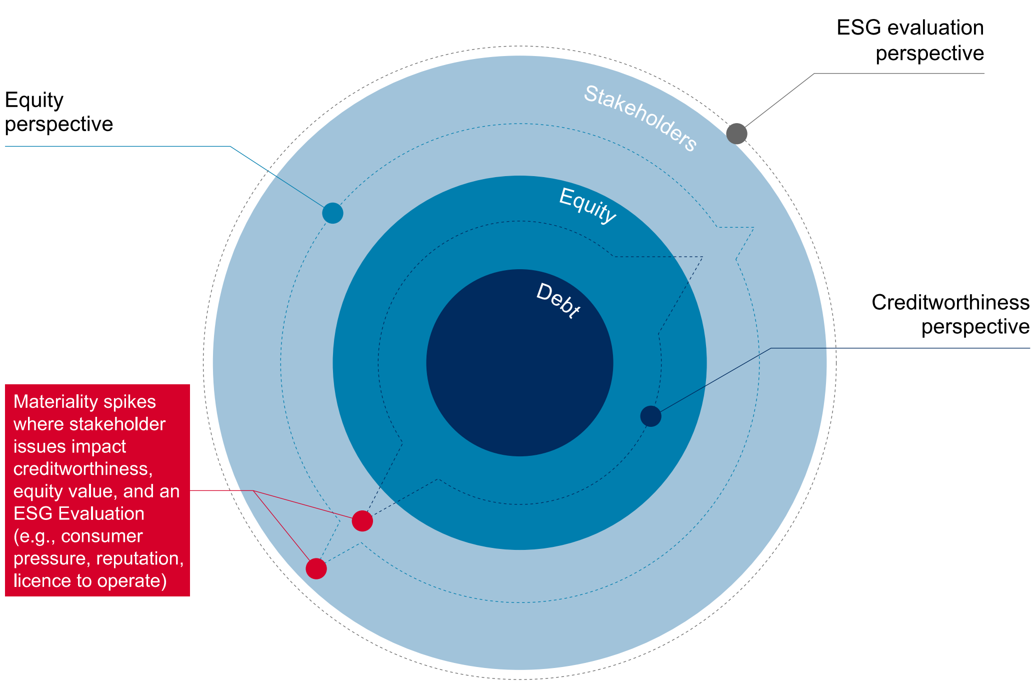
Our ESG Evaluation is not part of our credit rating methodology. However, we do consider certain related factors. For example, "Management And Governance Credit Factors For Corporate Entities And Insurers," published Nov. 13, 2012, references the management of environmental and social risks and the oversight of these risks by a company's board of directors. In addition, we have published various articles illustrating how our existing ratings criteria incorporate ESG risks and opportunities across all sectors and assets classes, including financial institutions, insurance, sovereign and local governments, and public finance entities.

The ESG Evaluation will be offered separately from our credit ratings to provide greater transparency into all aspects of ESG risks and opportunities. The distinction between ESG in credit ratings and our new ESG Evaluation can be best understood by considering the impact of ESG analysis in our respective analytical opinions. Our credit ratings are our opinion of an issuer's ability and willingness to meet its financial obligations in full and on time. As a result, when an ESG factor is material enough to influence our opinion of industry risk, competitive position, management and governance, or our cash flow and leverage forecasts, ESG analysis is relevant in our credit rating. But, a very strong balance sheet and cash flow can materially offset ESG risks in a credit rating.

The analysis of ESG factors will always influence the ESG Evaluation unless an E, S, or G factor is unlikely to ever have a financial impact on an entity in the future. We may conclude that some longer-term and less certain or less direct risks and opportunities are material for the ESG Evaluation, but not so much for the credit rating.

Chart 1

ESG Evaluation Perspective, Creditworthiness Perspective and Equity Perspective



What is the link between a credit rating and ESG Evaluation?

There is no link between an ESG Evaluation and a credit rating--they are two separate opinions that apply different analytical frameworks. When assigning an ESG Evaluation to a rated entity, we do not expect to learn any new ESG-related information material enough to affect the credit rating. We do expect to use more detailed ESG-related information to determine the ESG Evaluation. There is a remote possibility we could uncover new ESG-related information that could be material to the credit rating. In that case, the credit analyst would review the information according to the relevant rating methodology.

How can I see how ESG factors affect credit ratings?

We have recently begun to disclose ESG sections in our credit rating reports. ESG considerations have always been captured in our credit rating analysis, often through competitive position, financial metrics, and industry risk, and institutional framework, among others. Analytically, this makes our ongoing efforts more transparent; as recent lookback studies we've conducted have shown, ESG risks have been very impactful for credit ratings (see the Related Research section).

Can an issuer with a high credit rating also have a relatively low ESG Evaluation score?

Yes. Take, for instance, a large oil and gas company. We would view this sector as having intermediate industry risk for ratings purposes, and with strong financial metrics, a broad geographic footprint, and some vertical integration, the company could easily be rated investment grade. This could be especially true if it has sufficient cash flow and relatively near-term maturities. But the same company could have a relatively low ESG score if it has a weak trajectory of carbon emissions, has a weak safety track record, and has had accounting irregularities in the past, or if it has not done long-term climate change scenario planning. Taken alone, these items might not be material to credit quality, but taken collectively they perhaps create a mosaic for ESG Evaluation purposes of a company with less sustainable long-term prospects.

Of course, the opposite could also be true. For example, a small, highly leveraged company in a risky industry, such as metals and mining, may have a relatively low credit rating. But if that company shows a high level of transparency in its reporting on environmental metrics, has a plan to diversify into less risky businesses, and has invested in strong hiring practices and labor relations, it could be viewed as more sustainable longer term and therefore scored more highly under our ESG Evaluation.

How does S&P Global Ratings' ESG Risk Atlas factor into the ESG Evaluation?

The ESG Risk Atlas is a foundational component of our ESG Evaluation and is based on the analytical insights of our credit teams that cover various sectors. It represents cross-sector analysis; that is, we consider the relative risk levels between industries and between countries based on a collection of data and our analytical expertise.

The Risk Atlas effectively sets a baseline risk level for us to approach each ESG factor for each respective industry and country. From this, we measure entity-specific attributes as they compare against industry and country norms to determine relative performance, and this composite helps inform the ESG profile score.

How does the ESG Evaluation account for entities that may operate in numerous jurisdictions with varying degrees of governance risk?

The head office jurisdiction typically is most important for governance because an entity will be primarily subject to the governance and regulatory requirements of the country it is headquartered in. An entity's policies also typically originate from its head office, in line with the jurisdiction's practices.

However, in certain cases we may choose to weigh other locations more prominently. For instance, if subsidiaries can operate with a high degree of autonomy, this may indicate that local governance standards are more applicable than those in the head office country. Alternatively, an entity may be headquartered in a country with relatively weak governance standards, but if it has significant operations in a country with much higher standards and chooses to adhere to those higher standards in all jurisdictions where it operates, we could adjust the entity's governance profile score to account for this stronger performance. The opposite is also true. A company headquartered in a country with very high governance standards but that does most of its business in countries with substantially lower standards and adheres to only local norms in its practices would potentially benefit from the high head office score but be adjusted to reflect significant variation in its practices.

Which data sources does S&P Global Ratings rely on for the quantitative aspects of the evaluation?

The list of quantitative metrics that we consider under each factor within the ESG profile leverages the existing reporting frameworks including the Global Reporting Initiative, the Greenhouse Gas Protocol, Climate Disclosure Project, the Taskforce for Financial-Related Climate Disclosures recommendations, the U.S. Occupational Safety and Health Administration reporting metrics, and the World Resource Institute's definitions of water accounting. This allows us to leverage existing expertise to measure nonfinancial key performance indicators that entities are familiar with and equipped to measure. While some of this reporting is voluntary and often non-standardized, we ask whether these metrics have been assured by a third party and calculate our own ratios to assess entities in a comparable manner.

We develop our quantitative view of an entity's ESG performance by leveraging entity-specific ESG data that we hold internally as part of the S&P Global Ratings and S&P Global Market Intelligence divisions, including data from TruCost. We also request each entity's ESG information through our ESG diagnostic. The ESG diagnostic is our main tool to normalize different ESG reporting practices and fill in gaps to measure ESG performance, in particular for non-listed, private, smaller companies, and non-corporates.

Data and quantitative models only tell part of the story, so at each stage in the ESG Evaluation process our analysts review and may apply analytic adjustments where appropriate to more accurately reflect our view of the ESG risk exposure and the performance of a sector, region, and entity.

What must an entity do in order to be assessed as Leading for any factor?

As mentioned in our analytical approach, we assess each of the eight factors in the Environmental and Social Profiles from Weak to Leading, and Developing to Leading in the four factors of the Governance Profile, all on a relative basis. Leading is reserved for the very best performers, and will be used rarely. Some examples of the characteristics we typically associate with Leading include:

- Empirical evidence of significant and consistent outperformance against other strong performers, usually with a positive trend into the future. Multiple metrics would support Leading performance more than a single metric alone.
- Some evidence that the entity has avoided material adverse ESG events for a protracted period, and not merely through good fortune.
- A comprehensive set of effective and transparent policies and procedures covering the factor being assessed, which well surpass those of peers.

How does S&P Global Ratings use Cyence to inform its cyber risk score?

We leverage the S&P Global Cyber Risk Intelligence & Surveillance Platform to measure the perceived relative exposure to cyber risks. The approach considers 40 factors such as detecting for bad activity (including spam), leaked information on the dark web (e.g. compromised user passwords), technology and infrastructure, and people-related factors (e.g. employee sentiment).

However, we note that this platform does not provide a complete picture of the threats a company faces, nor the efforts it has taken to mitigate them. Our ESG Evaluation relies heavily on our access to management, and this is especially true for cyber risk, where entities may be hesitant to publicly disclose excessive information.

Will S&P Global Ratings consider an entity's entire value chain in making its evaluation? If so, how?

To derive an ESG Evaluation score, we consider a company's direct ESG exposures, as well as those it faces indirectly via other participants in its value chain. In many cases, the risks an entity faces outside its own purview can be more significant and, perhaps as importantly, more difficult to mitigate. Our experience has been that large, public companies provide the most robust reporting and awareness of ESG risks. However, many of them rely on either suppliers or customers that have less obvious commitments to sustainability and whose exposures can disrupt the whole value chain, from the raw material producer to the end user.

Our methodology calls for us to use a combination of quantitative data and qualitative judgements, which are critical for capturing the prospects for risk and opportunity within the value chain. While we collect several data points on both key performance indicators and policies and procedures, they often only capture the performance of the entity being directly evaluated. A thorough ESG analysis includes how ESG is managed by suppliers, customers, and other counterparties in an investment or lending portfolio, and we may adjust scores qualitatively to reflect the absence of data on this point.

For example, we may perform an ESG Evaluation for a small electric utility that has very proactively addressed its own greenhouse gas emissions levels and has improved its safety metrics dramatically. These strengths may all suggest a relatively high score. However, if the same utility, for example, purchases gas from a heavily emitting producer through a single pipeline with a history of destructive and polluting gas leaks, it could have a higher level of indirect environmental exposure. A greenhouse gas emissions score of Leading could theoretically be lowered to Strong on the grounds that its supplier's greenhouse gas emissions could create exposure. Of course, we consider this in the context of financial materiality, and the more distant a counterparty is in the value chain, the less likely those exposures will ultimately have a material financial impact.

How can ESG-related events affect your analysis under the ESG Evaluation analytical approach?

ESG-related events can be highly influential to ESG analysis, for instance natural disasters, labor disputes, and data breaches. The standard we use for assessing whether to include events in our analysis and subsequently disclose them in our reports is whether or not they would likely be financially material to our analysis of the company. Consequently, a management team that has faced signficant adverse events but somewhat mitigated them might be less affected. Also, in our opinion, if there are multiple instances of similar events that are financially material to our analysis, they are more likely to repeat in the future and their frequency suggests that management may not be responding to them effectively.

The data points we use may not always capture the impact of events, especially recent ones. Our data capture of events looks back 10 years, and on the basis of financially material events during this timeframe we may override scores suggested by our data points, especially if the event is relevant to one factor. For instance, a company may show carbon emissions levels and a trajectory that are Best in Class for its industry, but if it has also had a recent, high-profile methane leak, we might amend its greenhouse gas emissions score to reflect that event.

Material ESG events for the purposes of our analysis are generally unforeseen and, if impactful, will require management's attention. Consequently, while such events could influence data points that can modify the score, we'll also take into account qualitative considerations such as how management addresses the issue. These events can result in an adjustment to the score, either at the factor level (if they appear to be factor-specific), at the profile level (if they apply to more than one factor), or at the ESG profile level (if they cut across ESG factors).

Will a comparative analysis be part of the ESG Evaluation?

Because an ESG Evaluation is a relative ranking of how an entity fares against its industry and regional peers, comparative analysis is critical to formulating a score. As noted, our Risk Atlas captures the baseline exposure an entity faces based on its industry and location, and our performance data and policies and procedures information lead to an indicative score.

However, within each of the 12 factors we score, we may use analytical discretion to override the suggested score based on a particularly positive or negative comparison with industry and regional baselines. For example, an agricultural company that has been particularly proactive in reducing its water use but that has historical figures that belie this, might have its factor score raised from Good to Strong if we believe it's poised to fare as well as other companies in its industry with better data and that are already scored as Strong. We may make similar adjustments at various points throughout our analysis.

What interactions does S&P Global Ratings use to form its preparedness opinion?

The long-term preparedness opinion reflects our qualitative view of an entity's capacity to anticipate and adapt to a variety of plausible long-term disruptions and therefore support the entity's long-term sustainability. We can be informed by several sources, chief among them is our discussion with management and members of the board of directors. Our preparedness meeting is geared toward understanding, more holistically, how the entity, specifically the management team and board members, identifies, acknowledges, assesses, and acts on risk and opportunity. Given that these risks often revolve around environmental or social factors, this discussion may include sustainability personnel and senior management. However, because effective oversight is important, these meetings will also include board members who can speak to their role in developing a sustainable strategy.

Are there any types of companies (tobacco or mining companies, for instance) that will automatically score poorly under an ESG Evaluation?

While we omit any moral or ethical judgment from our analysis, society's judgments can be impactful, and the potential impacts of social movements against certain products or even whole industries are meant to be captured in our ESG Risk Atlas. Consequently, entities in these industries (and other highly exposed industries) may start off with a weak sector score, which means they'd be predisposed to a weaker overall ESG Evaluation score--if they scored in line with broader industry standards.

However, within each sector, some companies or entities will fare worse than average and some better than average, and the latter will mitigate some of the industry's exposures and score better. This can be through:

- Outperformance on key metrics against industry standards (for instance, a utility that has lower greenhouse gas emissions because it has closed coal plants).
- Highly effective governance (for instance, very high levels of transparency and disclosure).
- Relatively effective preparedness (for instance, a tobacco company that is pursuing acquisitions in less exposed industries).

As this is a monitored evaluation, what could cause S&P Global Ratings to adjust a published ESG Evaluation score?

We will monitor the company or entity and related events and their impact on the ESG Evaluation to determine if it has a material impact on our analytical rationale or the score. First, when we receive new data, whether through the publicly available corporate sustainability report or through privately furnished information, we may update the ESG Evaluation if we believe the changes are significant to our analysis. Second, we'll keep close watch over events that can affect the ESG Evaluation score. A major ESG-related event could prompt a review, and often the outcome could be negative. An event that is embarrassing but unlikely to lead to a financial impact, may not prompt a review.

Related Research

- Environmental, Social, And Governance Evaluation Analytical Approach, April 10, 2019
- The ESG Advantage: Exploring Links To Corporate Financial Performance, April 8, 2019
- When U.S. Public Finance Ratings Change, ESG Factors Are Often The Reason, March 28, 2019
- How Management & Governance Risks And Opportunities Factor Into Global Corporate Ratings, Nov. 7, 2018

- How Environmental, Social, And Governance Factors Help Shape The Ratings On Governments, Insurers, And Financial Institutions, Oct. 23, 2018
- The Rise Of ESG In Fixed Income, Sept. 10, 2018
- The Effects Of Weather Events On Corporate Earnings Are Gathering Force, June 11, 2018
- How Social Risks And Opportunities Factor Into Global Corporate Ratings, April 11, 2018
- How Environmental And Climate Risks And Opportunities Factor Into Global Corporate Ratings - An Update, Nov. 9, 2017
- Green Evaluation Analytical Approach, April 26, 2017

External resources

- Global Reporting Initiative, the Greenhouse Gas Protocol
- Taskforce for Financial-Related Climate Disclosures
- U.S. Occupational Safety and Health Administration
- World Resource Institute
- World Bank's Human Capital, Rule of Law, and Control of Corruption indices
- Transparency International's Perception of Corruption,
- UNISDR Global Assessment Report
- World Health Organization's Global Health Estimates

This report does not constitute a rating action.

The ESG Evaluation is not a credit rating, a measure of credit risk, or a component of our credit rating methodology. However, the information we gather for an ESG Evaluation can inform our credit analysis of rated entities.

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