Institute for Energy Economics and Financial Analysis

Fact Sheet

Can credit rating assessments and sustainability coexist?

Credit ratings are not directly related to environmental, social and governance (ESG) practices. IEEFA proposes two models for how to merge ESG factors into credit assessments, to see if creditworthiness and sustainability can coexist in ratings.

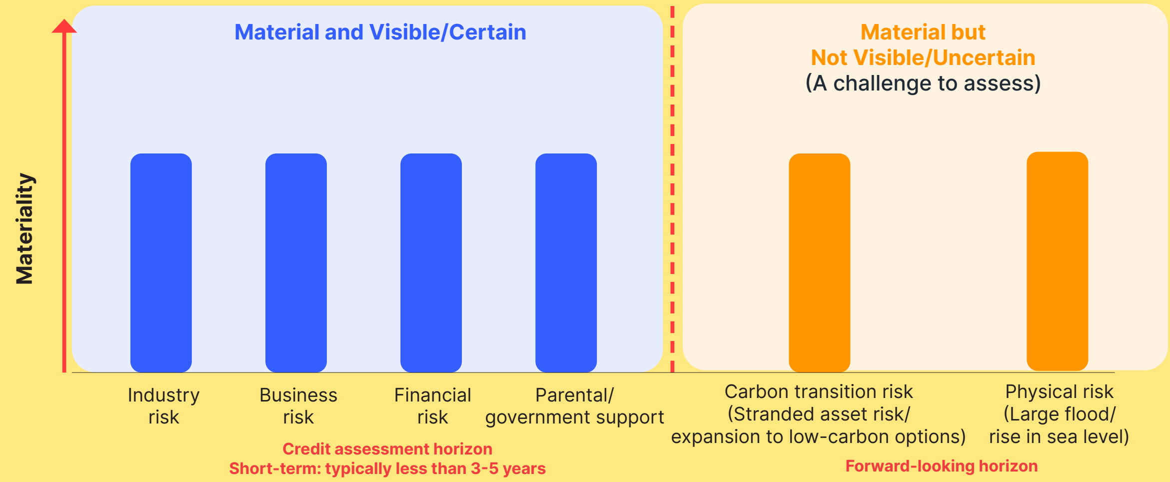
Ratings have evolved in addressing credit risk on the hydrocarbon sector. While rating agencies have begun to consider climate-related risk, they still need more tangible credit rating action on issuers.

Key takeaways from IEEFA study

- A detailed ESG diagnosis is not the same as integrating ESG factors into ratings, since the former does not trigger a credit rating action.
- A company with a weak ESG credit score can have high credit ratings, based on IEEFA's study of 721 firms.
- The current credit rating model is short-sighted. An issuer that faces heightened ESG risks in the long term, particularly climate-related risks, may experience abrupt rating changes sooner than expected.

For ESG risks to be adequately represented in credit ratings, it is crucial to integrate ESG factors, particularly climate-related factors and forward-looking time horizons.

Long-term Time Horizon Assessment in Credit Analysis



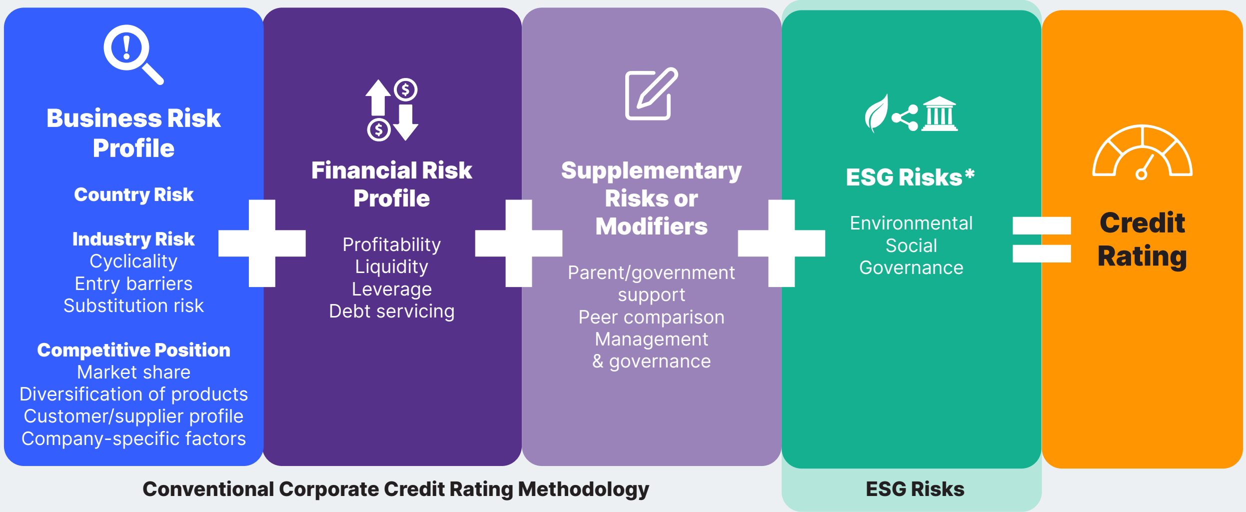
Source: IEEFA analysis

> The current methodology does not drive debt financing to sustainable initiatives. Bondholders may continue to support businesses that have poor green standards.
>
> Just as businesses and risk managers are expected to think beyond the short term, credit assessment must evolve to ensure the rating system, too, promotes sustainability.

Hazel Ilango
Energy Finance Analyst, IEEFA

Proposed Models for Integrating ESG Factors in Credit Ratings

Proposal 1: Expanded Credit Assessment Model



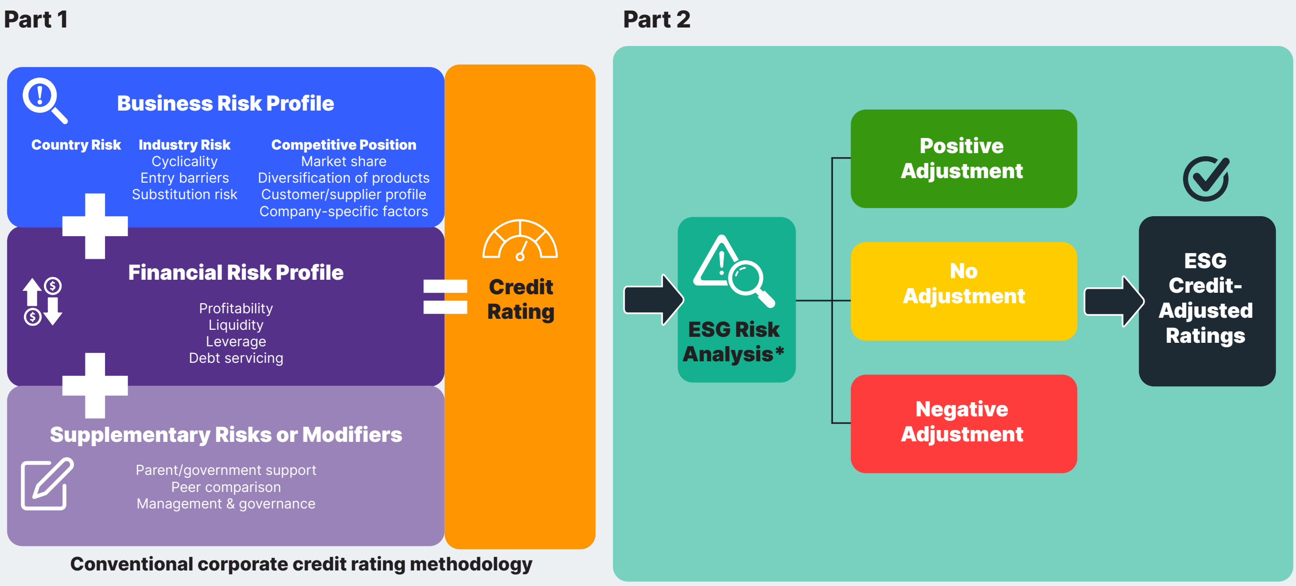
Conventional Corporate Credit Rating Methodology
Equation: Business Risk Profile + Financial Risk + Supplementary Risks (Rating change by a few notches) = Final Credit Rating

Conventional Corporate Credit Rating Methodology + ESG Risks
Equation: Business Risk Profile + Financial Risk + Supplementary Risks (Rating change by a few notches) + ESG Risks = Final Credit Rating

Source: IEEFA analysis. *Alternatively, only for environment (E) and social risks (S) as governance (G) may be incorporated under supplementary risks or modifiers

Proposal 2: Double Rating Model

- **Part 1 represents the status quo of a conventional credit rating methodology which results in a final credit rating**
- **Part 2 represents an ESG credit-adjusted rating which is an ESG risk overlay of the credit rating outcome in Part 1**



Source: IEEFA analysis. *Alternatively, only for environment (E) and social risks (S) as governance (G) may be incorporated under supplementary risks or modifiers

About IEEFA

The Institute for Energy Economics and Financial Analysis (IEEFA) examines issues related to energy markets, trends and policies. The Institute's mission is to accelerate the transition to a diverse, sustainable and profitable energy economy.

www.ieefa.org