Proactive Risk Management of Climate Change Youth Forum Research Result 5

Comparative Analysis of ESG Rating Systems and Credit Rating Systems

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Environmental, social and governance (ESG) ratings and credit ratings adopt similar frameworks, both of which are manifested as a set of quantitative and qualitative evaluation metrics for enterprises, but the two are obviously different in methodology, consistency of results, scope and purpose of application, and time period. The former better reflects the requirements of green and low-carbon development trends, while the latter underpins and secures the operation and management of modern commercial banks. By identifying the differences between ESG rating and credit crating and closely integrating factors rated to the former into the latter systems, CCB will better adapt to the requirements put forth by the new development stage, serve the high-quality development of the real economy, and contribute to the realization of the goal to peak carbon emissions and achieve carbon neutrality on all fronts.

I. Differences between ESG rating systems and credit rating systems

CCB's existing credit rating systems have included some ESG factors. Below are some examples in this regard. Corporate governance is incorporated in the evaluation of corporate fundamentals; at the step of exception-based adjustment, negative events, lawsuits, and abnormal changes in the Senior Management in relation to environment are taken into account; in the process of credit enhancement, the environmental performance of customers, such as energy saving and emission reduction, and low carbon emission is listed as one of the evaluation factors. In terms of the overall rating framework, ESG rating systems and credit rating systems have the following differences.

First, technical methodologies. Credit ratings focus on the financial and operational position of a rated entity. According to the rating methodologies adopted by Moody's, S&P and Fitch, corporate credit ratings give preference to the analysis of operational and financial risks facing enterprises. A combination of quantitative and qualitative methods is used to assess entities and produce their credit ratings after qualitative adjustment. At present, credit ratings tend to adopt relatively consistent methodologies. Accordingly, related standards and rules are so mature that they are extensively and thoroughly applied by banking financial institutions. By contrast, ESG ratings are intended to indicate the directions in which enterprises make their long-term investments, while taking into account the benefits for economic and social sustainability. The technical methodologies are meant to deal with more diversified levels and dimensions. Since there are no unified ESG rating standards available at home or abroad, financial institutions understand ESG concepts at varying levels. In short, the ESG rating practice of banking financial institutions is still in the initial period.

Second, consistency of rating results. In practice, external rating agencies usually produce steadily consistent credit rating results. Taking the external credit ratings of the big five banks in China for example, there is a correlation of 0.85 among the ratings on the same bank by S&P, Moody's, Lianhe Ratings, and China Chengxin International Credit Rating. On the contrary, ESG rating results are more likely to be inconsistent. The latest ESG rating results in 2020 from Sino-Securities Index Information Service, FTSE Russell, SynTao Green Finance, and China Alliance of Social Value Investment (CASVI) revealed an average correlation of as low as 0.2. Therefore, it can be concluded that rating agencies have not reached a consensus on the ESG ratings of the same entities.

Third, the scope and purpose of ratings. In practice, the entities subject to credit ratings are the issuer enterprises in the bond market and the stock market, both of which can produce highly recognized credit ratings to evaluate the solvency of enterprises. ESG rating systems and related data/information services are mainly available on the stock market to evaluate the sustainability of enterprises.

Fourth, time span of rating windows. Generally, credit ratings have a window period of one year, which is basically in line with the financial reporting cycle of enterprises. In this sense, credit ratings are more oriented to the prediction of short-term risk levels. In contrast, ESG ratings have a longer time span, because it may take five years or even longer to assess potential risk changes.

II. Fully consider the suggestion to optimize credit rating systems using ESG elements

At present, many international rating agencies apply ESG rating factors to credit analysis and rush to acquire international ESG research institutions as a move to participate in ESG business. The change attests to the integrated development of credit rating and

ESG rating. For the next step, credit rating systems can draw on ESG rating results and factors for continuous self-improvement.

First, ESG rating results are used to know well credit risk of enterprises over the long term. ESG rating is intended to take an overall look at enterprises from the perspective of environment, society and corporate governance. Good ESG ratings indicate that strengthened emphasis on ESG can help companies create tangible and intangible value and reflect their capacity and capability to attain sustainable development. ESG ratings can systematically reveal companies' capacity and capability to realize sustainable development, thus spreading among market players the global trends and regulatory requirements such as positive response to green development and responsible investment. Overall, ESG ratings can provide additional information on the future operating capacity, growth potential, and development prospects of enterprises. If used as an effective means to grasp the long-term credit rating trends of enterprises, they will make risk control further far-sighted.

Second, ESG ratings are referred to optimize corporate governance evaluation methods. In ESG ratings, quality of financial information disclosure is one dimension used to indicate corporate governance and long-term sustainability of enterprises, which can be assessed with many underlying metrics, such as punctual disclosure of financial reports or not, likelihood of falsified financial reports, interest affiliation with accounting firms, internal control audits of enterprises, and availability of channels for information disclosure to the public. Corporate governance risks and adverse effects derived from the information disclosure dimension often precede the possible deterioration of financial conditions and credit levels for enterprises. In addition, the involvement of directors, supervisors, and senior management members in litigation or arbitration will also undermine corporate governance performance. At the same time, the violations of laws and regulations by directors, supervisors, and senior management members will have a negative impact on the "moral quality" of enterprises, causing them goodwill losses and further hurting their credit levels.

Third, environmental and climate risk factors should be fully considered in credit rating as they are in ESG rating. Environmental assessment as part of ESG rating suggests that the impact of environmental protection and climate change on long-term business performance expresses itself as the impact of pollution prevention/abatement and environmental management on corporate solvency. On the one hand, companies that attach great importance to improving environmental performance tend to increase their investment in innovative environmental technologies and green strategies. In turn, companies manage to boost their economic imperative from the perspective of sustainable development, which ultimately translates into their solvency. On the other hand, companies that seek sustainable development usually have good operating conditions, great solvency, and ample liquidity. So it is less likely for them to resort to environmental fraud or violation as a means to reduce cost. In comparison, some companies with poor operating conditions are more likely to create the fiction of good performance through environmental violation.

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