

# ESG ratings for corporate bonds – why do we care and why should you care?

Rob Mathews, Ben Bierwirth and Elaine Baynham of Baker McKenzie consider some of the challenges posed by ESG ratings in the context of debt securities offerings

## What are ESG ratings?

Environmental, social and governance (ESG) ratings are a discrete assessment of a company's ESG performance. This is separate from the ESG factors considered within credit rating agencies' review of a company's creditworthiness. To date, there is no consensus as to how these ratings should be made and what they should reflect. Are we rating ESG risk or ESG impact? Should the ratings reflect the company's ESG profile or the ESG footprint of a particular transaction or instrument? In this article, we consider the following in the context of debt securities offerings:

- How material are such ratings?
- Should these ratings be disclosed (whether or not required)?
- If yes, what other considerations arise for the offering process?

At the root of this challenge is the issue of how companies collect ESG data and the underlying subjective and inconsistent nature of the standards. While ESG data and ESG ratings are both forms of measurement, ESG data collection is the first step of gathering and sorting the underlying data, which is then subject to analysis and evaluation in the calculation of the ESG rating. Different concerns surround disclosure and regulation of both ESG data and ESG ratings, especially as investor focus (and therefore scrutiny) increases.

## Where do ESG ratings come from?

As yet, there is no market standard or consolidated organisation of the wide-ranging analytics programs and companies created to capture ESG data. Generally speaking, these platforms range from accessing raw information to presenting and organising the information in a more user-friendly and accessible format. At the end of the day, all of these services are aiming to measure ESG impact. But how does one measure impact?

## 1 MINUTE READ

In addition to the traditional (corporate and/or securities-based) ratings commonly obtained by an issuer in connection with an international debt offering, corporates may now avail themselves of a new metric – the ESG rating. To date, there is no consensus on how ESG ratings, which assess a company's ESG performance, are derived or what they reflect. As more corporate bonds are issued linked to ESG ratings, these ratings will become more material, and a consensus around how ESG ratings should be disclosed and regulated will directly impact their reliability. In this article, Baker McKenzie lawyers consider some of the challenges posed by ESG ratings in the context of debt securities offerings.

Debate continues around the underlying ESG data in terms of emphasis, weight, scope of measurement and key definitions. As there are no standardised or qualified parameters to the collection and measurement of ESG data, each ESG data provider must consider the multitude of ESG factors and ESG analysis metrics subjectively when applying its own, distinct, chosen methodology.

In addition, ESG rating services are typically investor-pay subscription services, in contrast to credit rating agencies which are engaged by the rated company. This leads to a more limited pool of information being available to ESG rating agencies, where the data is often restricted to publicly available information and the agency may not benefit from direct access to management in preparing and assessing the ratings. These data gaps further exacerbate the differences in methodology and resultant ratings.

As such, in contrast to credit ratings – where there is usually little divergence among credit rating agencies, the understanding of creditworthiness is more universal and generally definable, and the building blocks of the underlying analysis are broadly comparable – ESG performance ratings vary significantly between agencies, thereby making it more difficult for market participants to analyse, evaluate and, ultimately, rely on them.

### Why do we need ESG ratings?

The genesis of these ratings is strong stakeholder demand in the market, but ESG ratings can also serve a variety of additional purposes. Giving an ESG rating to debt instruments, for instance, has been seen positively to impact pricing as well as satisfy investor mandates or requirements, stabilise third-party review and verification, provide a proactive narrative and messaging, differentiate from instruments which are not green, pre-empt regulatory and risk management requirements, and reduce insurance cost and litigation. ESG ratings also provide important insights beyond simply evaluating a company or transaction. For example, uniform ESG data can help at every step of a company's and investor's choice of whom they partner with, and where and how they source materials. As such, effective ratings can support the broader evolution of an ESG-minded economy.

As ESG factors become a key area of focus throughout the world, the demand

increases for information surrounding these factors as a result.

Looking specifically at the debt markets, very much like credit ratings, ESG ratings can provide a useful tool for investors in making investment decisions with regards to green, social and sustainability debt instruments and sustainability-linked debt instruments, which have shown exponential growth since the first few issuances between 2005 and 2008, and in particular in the last five years. Moreover, this rising trend is not only expected to continue, but also to gather momentum as we move further towards the goals of the Paris Agreement on the journey to net zero. However, as a result of the accelerated growth of this market, disclosure rules and regulatory practice for these instruments are still playing catch-up in the effort to build a standardised market practice that can support and facilitate reliable investor scrutiny.

The key in this area will be managing different policy approaches. In certain circumstances, policy may be better regulated by market forces and participants themselves, but to ensure standardisation and comparability of the resulting ratings, a number of rules and regulations may also be needed.

### What are the challenges for ESG ratings?

As with ESG data service platforms, each ESG rating agency considers the multitude of ESG data and analysis metrics and applies its own subjective methodology, such that there is a wide divergence in what the ESG ratings actually cover and what they really mean. Therefore, a lack of transparency, comparability and reliability exists in the market of ESG ratings and data product.

In an ideal world, ESG rating agencies should be transparent on the methodologies utilised to collect, measure and display data, as well as what the data is intended to measure and how it will be used. However, at present, it is not always clear how ESG rating agencies are sourcing and updating information, or how they are determining or updating ratings over time, which makes it difficult to replicate ratings and assess their value. In certain instances, the same company may end up with multiple ratings, and even with high scores from one agency and low scores from another. With greater transparency over methodologies, both companies and investors would be able to

recognise the factors yielding different ratings among different agencies and market standards could be developed. Perhaps most importantly, ESG rating agencies need to be more specific about the intended use of the rating: whether it is measuring ESG risk or ESG impact.

Companies and investors need to understand both the sources and uses for ESG ratings in order to have confidence in the comparability and reliability of the ratings. Large discrepancies in data and metrics can lead to low correlation and high divergence in ESG ratings, even though the agencies are ultimately trying to measure the same ESG impact. This makes ratings less reliable and comparable.

A further challenge to external rating agencies lies in companies' own internal ESG ratings. Here, more profitable companies can undertake and expend more resources on internal assessments, which can lack the independence of external rating agencies and negatively affect the comparability of ESG ratings. Without the objectivity and consistency of methodologies, the effectiveness of reliable ESG data is diminished and loses value for investors. Transparency allows for better understanding of how a result is obtained and, as transparency increases, the market can align methodology in order to become more systematic and objective.

Building transparent and systematic methods of research in which ESG rating agencies can measure and rate will lessen the discrepancies caused by relying only on publicly available information, and clarify assumptions and their impact on the analysis. The more specific the data and transparent the methodology, the higher the confidence in the ratings.

### Are ESG ratings regulated?

At present, there are no legally binding regulations applicable to ESG ratings. Given the array of regional and sectoral nuances, introduction of a regulated ESG economy will vary among jurisdictions and industries. As a result, a universal single system to govern ESG ratings will unlikely be achievable or effective. A more immediate, and perhaps more successful, approach would be an application of clear, comprehensive global guidance across countries and businesses. However, it is important to maintain enough generality to support regional and sectoral nuances such

that any framework is usable and applicable universally.

In the EU, regulations around ESG ratings are in their nascent stage. The EU Corporate Sustainability Reporting Directive, once agreed and brought into force, is intended to amend the existing reporting requirements of the Non-Financial Reporting Directive (Directive 2014/95/EU), extending the scope to all large companies and all companies listed on regulated markets and introducing more detailed reporting requirements, as well as a requirement to report according to mandatory EU sustainability reporting standards. The European Financial Reporting Advisory Group is working on these sustainability reporting standards, aiming to have the first set of draft standards ready by mid-2022, such that the European Commission might adopt them under the new legislation, ideally by the end of October 2022. That would mean that companies would apply the standards for the first time to reports published in 2024, covering financial year 2023. A second set of complementary standards, which would include sector-specific information, would then likely be adopted by October 2023.

In the US, the Securities and Exchange Commission (SEC) recently determined it would set specific ESG reporting requirements for listed companies around climate change disclosure and human capital management disclosure related to ESG factors. The next set of information is

expected in April 2022. The expectation is that the SEC rules will focus on disclosure, but it is unclear how significant these rules will be. So far, predictions suggest that the SEC requirements will be focused more narrowly on financial results, but there is time yet for debate.

From a practical perspective, market participants and stakeholders such as AFME, ICMA, LSTA, LMA and APLMA, among many others, are putting together white papers, guidance and discussion groups in order to help guide market practice and assist in the regulatory efforts and developments. Also in January, the Securities and Exchange Board of India (SEBI) published a consulting paper indicating it will begin regulating ESG ratings. In doing so, India could become the first country to regulate the ESG ratings provider market.

### Going forward

While making ESG ratings transparent, comparable and reliable necessitates a large degree of standardisation, there must remain some flexibility. The ESG market is developing rapidly and, as it evolves and grows, so too the need for ESG ratings and data so that market participants and investors are provided with the full picture. Different regions and sectors will have different risks and opportunities. Even within similar regions and sectors, companies operate with different models and goals. Development of a set of industry standards through a systematic

approach to ESG rating sources, methodologies and the resulting measurements will help create a reliable means by which companies' ESG risk and impact ratings are understood. Best practices may include a transparent objective, scope and method, a set of standardised principles, universally defined terms and template disclosures to make the ESG data collection and ESG rating measurement comparable and reliable among the diverse set of regions and sectors in the ESG economy. High demand for ESG-related products and services has also led to many participants entering the market of ESG ratings services. We expect that as transparency, scrutiny and regulation of this area increases, the quality of the service providers will increase and the reliability of the resulting ratings will improve.



**Rob Mathews**  
Partner, London  
robert.mathews@  
bakermckenzie.com



**Ben Bierwirth**  
Senior Associate, London  
ben.bierwirth@  
bakermckenzie.com



**Elaine Baynham**  
Associate, London  
elaine.baynham@  
bakermckenzie.com