21-D-0827
October 25, 2021

Positioning of ESG Factors in Credit Ratings

Japan Credit Rating Agency, Ltd. (JCR) recognizes that ESG factors affect credit ratings and thus reflects them in the ratings. In light of the growing interest of society as a whole in ESG factors and rapid changes in the situation surrounding the rated entities, we have decided to reiterate our stance on the positioning of ESG factors in credit ratings. In addition, we will newly issue ESG Credit Outlook* to enhance the dissemination of information.

We at JCR expressed in September 2017 our view that ESG factors should be reflected in the ratings, noting that they affect the issuers' sustainability, cash flow generation capacity and financing ability. In January 2020, we stated that we would identify all ESG factors that could affect creditworthiness to be reflected in the ratings, taking into account their impacts on the business foundation and financial base and the timing of the emergence of such impacts.

As discussions on ESG factors have since then gone into greater depth in society, we have come to the conclusion that it should be taken into consideration that the issuers' responses to ESG factors not only generate additional costs, but also contribute to the creation of new business opportunities. Therefore, in making rating decisions, we will place more weight than before on the belief that creditworthiness could be improved or weakened, depending on how well responses to ESG factors are made. Also, even though ESG factors do not have direct, notable impacts on the business foundation or financial base in many cases for now, there are ESG factors that may have significant impacts in the future, thus requiring the management to be aware of such a fact and take measures already at this point. For this reason, we will categorize the impacts of ESG factors on the ratings into "current" and "future" and make rating decisions based on the idea that the management's stance on ESG factors is also a key evaluation item for the ratings.

(1) Success or failure of responses to ESG factors could help improve or weaken creditworthiness

We consider that "responding to ESG factors is essential to the issuers' medium- to long-term business continuity and its success or failure could also help improve or weaken creditworthiness." For instance, responding appropriately to ESG factors can lead to the absorption of future demand, differentiation from competitors and enhancement of industry position, thereby increasing the capacity to generate cash flows that exceed the investment burden. Conversely, curbing investment without responding to ESG factors could result in the loss of future business opportunities and a decline in the value of assets held, even if cash outflows were reduced in the short term.

As society's demands for ESG factors increase, there will also be new needs to be created, providing a greater leeway for the companies to find profit opportunities. At JCR, we will grasp the needs that are newly created for each industry and company and closely watch how much of them will be absorbed by individual companies and on what time horizon. We will consider balance between the needs that shrink with changes in the external environment and the acquisition of new opportunities and evaluate the business foundation accordingly.

Industries and individual companies whose decarbonization initiatives have major impacts on the core of their business, including high greenhouse gas emitting industries, have made remarkable efforts to establish targets for greenhouse gas reductions, develop business model conversion measures, etc. and to formulate transition strategies to that end to mitigate climate changes. While transition strategies often require large-scale investment plans for steady execution, there are many cases where they are expected to actually help maintain or expand the business foundation. In such cases, we will scrutinize the appropriateness and feasibility of the transition strategies, changes in the financial base as a result of the implementation of the plan and so forth.

(2) Management's stance on ESG factors is a key evaluation item for the ratings

We consider that whether the issuers' management has an accurate understanding of ESG factors as a management issue, whether countermeasures have been incorporated into the management plan and whether necessary measures have been taken to achieve them are also the items to be evaluated.

As so defined in “JCR's Rating Methodology,” we view “management plans” and “management” as the items to evaluate the business foundation. Today, ESG factors have become a management issue that has major impacts on the future of the business, and how they are dealt with affects the business foundation and financial base in the medium to long run. As noted above, if the continuity of appropriate responses has already become foreseeable, the business foundation will likely be maintained and expanded. On the other hand, if appropriate measures have not been taken, there arise concerns that the business foundation will be impaired over the medium to long term, even in cases where no notable changes are observed in the short term.

At present, many rated entities are taking measures in varying degrees, and there are few cases where the lag should be recognized as a clear risk. However, in the event that the gap between the measures taken and their outcomes becomes wider and wider among the companies as the target years for various goals, such as 2030 and 2050, come closer, it will be reflected in the ratings.

Management decisions on ESG factors affect not only the business foundation but also financing. In response to the growing awareness of the investors, new financing methods are being developed one after another. Major examples include: green bonds and sustainability bonds mainly for evaluating the use of funds, as well as loans associated with such bonds; and transition finance and positive impact finance that do not specify the use of funds. The issuers that can take advantage of these means can secure an advantage in terms of financing.

In terms of ESG factors and financing, the companies are drawing increasing attention to information disclosure, and there is a growing need for active efforts by the management. Enhancement of risk-opportunity analyses based on the TCFD guidance, disclosures based on the stewardship code, etc. will deepen the investors’ understanding and increase the likelihood that they will lead to smoother financing with favorable terms and conditions.

In the meantime, moves towards divestment for the industries with large environmental loads are also accelerating. Currently, there are few cases where this has direct impacts on individual ratings, but we are paying attention to future developments as financing is an item that could materially affect the ratings.

In addition, the market is becoming tougher on greenwashing, increasingly requiring the management to have a deep understanding, integrity and accountability. Therefore, the management’s commitment to ESG factors is now more important than ever in terms of financing and the evaluation of the financial base.

The standards and concepts concerning ESG factors in society as a whole have been constantly discussed among the parties concerned and will likely be revised from time to time in the future, too. We will continue to keep an eye on the direction of the discussions and update our views on its impacts on the ratings. We will also strive to enhance information dissemination by deepening communication with the issuers, investors and other rating users.

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* ESG Credit Outlook is a member-only report of RatingEye, a paid credit rating service.

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