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Necessity to Consider ESG Factors for Credit Ratings

Japan Credit Rating Agency, Ltd. (JCR) signed on September 15, 2017 an “Initiative on ESG in Credit Ratings Statement,” initiated by United Nations Principles for Responsible Investment (UNPRI). JCR has been incorporating CSR and other factors into its credit ratings, and decided to explain the current status concerning necessity of consideration of ESG (environment, social and governance) factors, taking the opportunity of the signing.

1. Introduction

JCR has been incorporating ESG factors to date from a viewpoint of CSR (corporate social responsibility). Please refer to JCR’s press release titled “CSR’s Position in Credit Rating,” dated December 28, 2004, published in Japanese only, etc. Along with recent firm establishment of 2 codes, stewardship and corporate governance codes, business and investment activities are changing. Understanding of concept of ESG is widely spread and there are an increasing number of cases where corporations and investors are taking measures for the ESG factors. In every region in Europe and U.S., ESG investments have been activated ahead of Japan. Japanese corporations which are well globalized, in particular, are strengthening initiatives for ESG issues.

It is necessary to consider ESG factors in assessment of various elements of JCR’s defined crating rating methodologies. JCR explains in this report afresh what kinds of elements can have an impact on credit ratings from a perspective of ESG factors.

2. Overview

JCR pays attention to the following elements for a possibility that ESG factors can have an impact on credit ratings:

- Impact by ESG factors on issuers’ sustainability
- Impact by ESG factors on cash flow generation capacity required for debt redemption
- Impact by initiatives for ESG on fundraising ability

JCR incorporates ESG factors that could come to the surface within approximately 3 years, because JCR decides credit ratings in view of debtors’ conditions and business environments in the coming 3 years or so.

JCR grasps issuers’ conditions for ESG factors through issuers’ general disclosure of information. Many Japanese issuers have been holding a series of discussions on enhancement of disclosures of information on ESG issues, and there are many cases where such disclosures have not reached a satisfactory level. To offset these conditions, JCR is making efforts to obtain more detailed information and accurate understanding through management interviews and other tools. In particular, JCR considers that management interviews are very important to check ways of governance.

3. Impact on Issuers’ Sustainability

JCR assigns a long-term issuer rating to debtors by grasping their overall debts in a comprehensive way. The long-term issuer rating is an assessment on creditworthiness of a debtor as a going concern, and an assessment as to whether the debtor can continue its business on an ongoing basis and can constantly create cash flows required for debt redemption. As ESG factors are highly related to debtor’s business continuity, analysis of ESG factors cannot be downplayed from this point of view.

Corporate management contains various risks, some of which are controlled by taking an proactive stance on ESG factors. From a perspective of this risk management, ESG factors are related to corporate sustainability.

4. Impact on Issuers' Cash Flow Generation Capacity

Credit ratings denote "certainty of fulfillment of debt obligations as initially agreed." Therefore, assessment of cash flows that are resources of repayment is important. JCR considers ESG factors as follows:

(1) Environment

JCR considers it is necessary to assess environmental factors from 2 approaches: (i) assessment of industrial characteristics themselves; and (ii) assessment of individual corporations.

In industries where environmental initiatives are required because, for example, they face issues such as large greenhouse gas emissions in their business development, corporations might be required to change their business portfolio in the medium and long run in addition to requirements for reduction of such emissions and raising environmental contributions from products. While JCR considers attention should be paid to a possibility that the current state of business structure or cash-in will drastically change in these industries, JCR in practice assigns credit ratings, focusing on risks that could come to the surface in the next 3 years or so.

JCR examines very carefully cash-in and cash-out for initiatives by individual corporations as follows: In terms of cash-in, JCR pays attention to presence of environmentally friendly products or services and their competitive strengths, given the fact that the number of consumers and corporations which place importance on environment is increasing. In terms of cash-out, JCR checks cost burden of environmental initiatives. In particular, manufacturing industries are required to take environmental considerations into account for raw materials procurement and waste in the manufacturing process and are being affected in many cases by strict regulations. Certain costs including costs for switchover of resources, capital investments, R&D investments, etc. are required in these cases.

(2) Social

Corporations are built on relations with many stakeholders rather than independently existing. It is indispensable to maintain an appropriate relationship with shareholders, customers, consumers, employees, and so on for smooth corporate business expansion.

In particular, labor shortage has become considerable and social requirements for improvement of work environment have intensified in recent years. Initiatives by corporations for these issues now influence their competitive strength and cash flow generation capacity.

(3) Governance

Transparency of management decision-making, appropriate management and supervision of business including that of subsidiaries and thorough compliance are becoming more and more important for sustainable business development of corporations.

While business activities have become increasingly globalized, there are many cases where external environments significantly change in a short period of time. It is essential to have a management structure in which corporations can fully discuss large investments, etc. in order to make a fast and accurate decision on such issues under these situations. JCR sees that an appropriate management decision can lead to an appropriate allocation of cash flows, investment and creation of future cash flows.

There are many scandals of corporate subsidiaries including overseas ones. It is becoming more and more important to establish a structure for ensuring accuracy in execution of business including that of subsidiaries to control inappropriate cash-out.

Stricter measures are required for compliance in recent years. Scandals with respect to compliance have a negative impact on business development and cash flow generation in various aspects. For this reason, it is indispensable not only to institute accurate and specific internal rules, but also to establish a structure where such rules can be applied in an appropriate manner including change of employees' awareness.

5. Impact on Issuers' Fundraising Ability

It is indispensable for a corporation to raise funds in a smooth and appropriate manner to expand business on a continuing basis. Ability to raise funds is an important factor for credit rating analysis. As ESG factors have become more important in making investment decisions by investors in recent years, impact of initiatives for ESG on their fundraising has also increased.

6. Impact of ESG Risk Events on Credit Rating

There have been already cases where ESG risk events could have become factors for credit rating changes in aspects of both qualitative and quantitative assessments. Given this situation, JCR always monitors presence of any risk events, and if there are any ESG risk events that have occurred, JCR grasps the outline and size of impact and reflects them in its credit ratings.

While assessment items and their importance differ depending on individual credit rating cases, the following are major items that are checked as an example.

(Example)

- Whether efforts for investigation to determine cause and for preventive measures are being made in an appropriate manner;
- Whether business expansion can be constrained by regulations and punishments;
- Where worsening of reputation can lead to a lower revenue and lower competitive strength;
- Whether a large amount of cash-out can occur due to compensation and restitution for damage;
- Whether remedial measures are associated with large cost increase;
- Whether fundraising can be adversely affected by worsening of business relations with financial institutions.

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