KBRA KROLL BOND RATING AGENCY

Credit Ratings Deserve ESG Risk Analysis, Not ESG Scores

Multi-Sector Research

KBRA's Approach to ESG Risk Management

In just 10 years, by remaining committed to investors' need for fundamental credit risk analysis, KBRA has grown into a global full-service rating agency. We have rated over 40,000 transactions, 2,800 entities, and over $2.25 trillion of debt across almost every sector. KBRA has also become a proven thought leader across a broad landscape of corporate, financial, and government (CFG) credit topics. KBRA has demonstrated a willingness to disrupt the status quo with more incisive analysis that is focused on our core mission—the assessment of default and recovery risk. We believe this approach serves markets better than the tendency by some to rely on old habits that have become detached from actual default experiences, or sometimes overreact to headlines. Consistent with this preference for fundamental credit rigor, KBRA has taken a decidedly different approach to incorporating environmental, social, and governance (ESG) risk analysis into our credit ratings, especially when compared to other rating agencies.

In KBRA's view, there are comparatively few ESG factors that materially impact the risk of default and recovery over the short to medium term for most CFG debt issues relative to the many ESG factors that are important to various stakeholders. Institutionally, KBRA embraces numerous ESG initiatives including efforts to improve the quality and frequency of issuers' disclosure. KBRA also embraces efforts to mitigate the effects of climate change and to improve social and racial equity. As a signatory to the UN Principles for Responsible Investment, KBRA publicly demonstrates this commitment to seeking a more sustainable financial system. In addition, we are committed to making our organization more diverse and inclusive, from working with experts on unconscious bias training, to partnering with HBCUs such as Howard University in recruiting talent to help shape the next generation of leaders in the credit market space. At KBRA, we pledge to continue looking for ways to make diversity and inclusion a reality.

And while many ESG factors play an important role in how we manage our business, and a growing role in helping investors preferentially allocate capital, we believe the role of analysts at a credit rating agency is to remain focused on ESG factors that are material to credit. Further, KBRA believes that the distinction between ESG factors that are credit-relevant or not is best accomplished through fundamental, bottom-up credit-by-credit risk analysis, rather than through the collection of often irrelevant ESG data and/or the creation of ESG scores that are burdensome to analysts and issuers. In our view, ESG scores based on subjective metrics that are not correlated to credit risk have no place in the credit rating process. Instead, KBRA analysts identify and integrate credit-relevant ESG factors through the lens of risk management analysis. We call this approach, ESG Management.

Through the lens of ESG Management analysis, KBRA integrates relevant ESG issues into our credit analysis without having to veer into subjective selection, scoring, and weighting of ESG factors that are not meaningfully credit-relevant. Our dialogue with issuer management teams on these topics increases our understanding of risks that may be around the corner, and/or strengths that go un-noticed in others' subjective ESG scoring rubrics, a process we believe leads to higher quality disclosure. While ESG scoring rubrics normatively choose and weight certain ESG topics (but ignore others), KBRA's approach allows for the analysis of those topics most relevant to a given issuer—and most impactful to credit.

Key Takeaways

- KBRA believes that credit-relevant ESG risks and opportunities are unique to every rating and issuer. Our approach to evaluating the management of ESG issues is a bespoke and dynamic process.
- KBRA does not deploy subjective value-based ESG scoring rubrics, and we do not distract issuers and investors with the burdensome collection of ESG data that are not impactful to credit.
- KBRA believes that ESG factors that impact credit risk need better disclosure and are best examined through the lens of risk management analysis for CFG debt issues and issuers. Under our ESG Management framework, we seek to understand the ways that a CFG issuer's management team can identify, address, and mitigate relevant ESG risks (or capitalize on opportunities), and/or the ways a specific transaction structure can mitigate these risks.
- Consistent with how we assess default and recovery risk, we view the management of ESG factors as a dynamic process along a continuum, rather than a point-in-time judgment.
- In addition to the idiosyncratic ESG risks related to each specific debt issue or issuer, KBRA's analysis of ESG Management typically includes a review of broadly relevant topics such as climate risk, cyber risk, and increasingly, the risks that the environmental, social, or governance policy preferences of key stakeholders (such as customers, regulators, employees, voters or investors) may impact an issuer's operating, capital, and financial plans, or, its reputation which is increasingly important for access to capital markets.

ESG Scores Are Not Part of KBRA Credit Analysis

In our extensive outreach to investors, their preferences have been clear and consistent. When it comes to ESG and credit risk, investors prefer more disclosure and transparency by issuers of *relevant and material* ESG-related factors, as well as deeper disclosure of an issuer's plans or a transaction's features that take these factors into account. ESG issues that are most often relevant and top of mind for credit-focused investors are those related to climate change, cybersecurity, and the impact that stakeholder preferences may have on operating and financial strategies.

ESG scores, by their nature, require a significant amount of subjective value-based judgments that are inconsistent with objective credit analysis. KBRA observes that ESG scores do not address credit risk, but tend to correlate only to the set of subjective standards upon which they are formed. Importantly, there is a danger that ESG scoring rubrics presented alongside a credit rating can give a false sense of precision, thereby distracting credit analysts from the fundamental nature of their work (i.e., default and recovery analysis) and could burden issuers with requests for extraneous data.

To be clear, KBRA understands the important role that certain ESG scores can play in helping equity and fixed income investors preferentially allocate investment capital. But such scoring rubrics must incorporate factors, weightings, and ratings that reflect those allocation preferences which inevitably go beyond the factors that are related to credit risk. KBRA believes the development, weighting, and ranking of the key factors in ESG scores are endeavors best left to investors rather than to rating agency credit analysts.

As an alternative to ESG scores, KBRA uses a two-step process to identify and integrate credit-relevant ESG considerations into our credit ratings analysis. First, we identify ESG factors with a direct impact on a given issuer or transaction. KBRA defines direct impact as those factors that have a clear, tangible effect on credit, are typically quantifiable, and the assessment of which is generally rooted in existing methodologies. In the second step, we seek to understand and encourage disclosure of a broader array of ESG-related risks or opportunities that may have more indirect or more future-oriented credit impact.

In either case, KBRA performs its ESG factors analysis through the lens of risk management analysis, which includes assessment of an issuer's ability to identify, plan for, and mitigate risks or to amplify opportunities.

KBRA's ESG Management Analysis Framework

KBRA believes that ESG risks and opportunities are best analyzed through a lens of how well these risks are being identified and managed by issuers and/or by their transactions. Indeed, the assessment of management plays a significant role in many of KBRA's rating methodologies, based on the premise that good credit risk analysis often needs to go deeper than headline numbers, ratios, and scorecards. Whether it is through our review of a management team's processes and strategies, or our analysis of how debt structures mitigate risks in project or investment fund transactions, KBRA analysts use credit-specific inquiry and analysis, rather than blunt and distracting instruments like ESG scores uncorrelated to default or recovery expectations.

Direct Impact

In the first step of KBRA's ESG Management framework CFG, KBRA analysts identify and integrate credit-relevant ESG factors for each debt issue just as for every other factor that impacts a credit rating. We present our analysis of these risks and strengths in relevant sections of our published reports. In 2021, in response to investor demand, we will also begin summarizing these views in a new section—ESG Management—in our published reports. Examples of direct and impactful ESG factors can include:

- A utility facing capital costs due to changing carbon regulation.
- A shipping company faced with refinancing risk due to its aging vessel fleet powered solely by fuel oil.
- An airline or OEM facing reduced access to capital markets because of carbon emissions.
- A city with significant taxable property value at risk due to sea-level rise.
- A hydroelectric project with weakened output caused by reduced snowpack runoff.
- A consumer products company facing boycotts because of lax workplace safety rules.
- An oil company facing higher capital costs due to a shrinking investor base.

Alternatively, KBRA also recognizes that certain ESG factors may positively impact credit for some debt issues or issuers, such as:

- A bank's competitive advantage due to a business model that focuses on the economic development needs in a given community.
- A clean energy firm that is seeing increased demand for its product.
- A corporation's aggressive and detailed mitigation of cyber risks.
- A state's aggressive capital and policy investments in local flood prevention measures, in response to increased intensity of storm events.
- An asset manager demonstrating the ability to expand its investor base after achieving a track record of strong investment performance of funds that target socially responsible investments.

We are also cognizant of powerful investor preferences toward ESG-favorable stories taking root in both debt and equity capital markets, which can result in meaningfully lower overall cost of capital.

Indirect Impact

KBRA believes that the relative ability of issuers to identify, disclose, and address a broader array of ESG factors which may be less direct or immediate is an increasingly important credit consideration. Such insights into ESG Management include:

Awareness:

- Does the management team or transaction sponsor demonstrate awareness of the tangible and intangible ways that climate, cyber, stakeholder preferences, or other ESG issues could impact their organization's or transaction's operating, financial, and capital strategies and assumptions?

Planning:

- Does the management team or transaction structure integrate these issues and the related scenario analyses into their financial planning?

Ability to execute:

- Can the issuer or the transaction structure afford the potential economic impact of these issues at a given rating level?

Common ESG Factors

KBRA observes that several ESG factors have the highest likelihood of being credit-relevant across the broad landscape of CFG debt issues or issuers. These factors include climate risk, cyber risk, and stakeholder preference risk. KBRA's approach to each is described below.

Climate Risk

Where relevant, KBRA analysts examine both physical and transition risks related to climate change. Physical risks such as extreme weather, sea-level rise, or drought, directly impact assets or business operations. In contrast, transition risks are indirect and relate to an entity's ability to shift to a lower-carbon economy because of potential changes to environmental regulations, supply and demand changes, and/or increased reputational risk.

Regarding physical risks, KBRA analysts will often request an issuer's analysis of the potential impact of climate change on its physical or financial assets such as operating facilities, revenue generating assets, or financial assets (e.g., insurance policies, business loans, etc.). In addition, when appropriate, KBRA seeks to understand the process through which an issuer determines its exposure. Though there are exceptions, KBRA believes this line of inquiry is increasingly relevant across most CFG issuer and issue types. In addition to the obvious importance of any insight into the potential timing and costs of mitigation efforts, KBRA also believes the process an issuer uses to analyze its exposure to climate change is credit-relevant because it provides insight into the robustness of its risk management practices. Given the significant geographic, scale, and timing uncertainties related to climate change, these analyses are commonly performed using one or more specific climate change scenarios.

When it comes to transition risks, KBRA believes it is credit-relevant to understand management's awareness of, and planning for, potential changes in climate-related law or regulations that may impact operations, capital plans, and changed behavior of upstream or downstream dependencies such as suppliers or customers. When relevant to credit, KBRA seeks to understand specific areas of transition risk (or opportunity) such as how an issuer measures its carbon footprint, and how the issuer may be integrating potential mandatory or voluntary carbon-related goals into its financial plans.

Some sectors, such as energy or utilities, may have more instances of issuers with identifiable transition risks associated with climate change. But ESG scores, even those that are customized for these sectors, can be weak tools for credit-

focused investors because these scores still lack the ability to distinguish the issuer- and geographic-specific credit-relevant factors that will impact the creditworthiness of a particular debt issue. For example, a new hydroelectric project may receive a high ESG score because of the renewable nature of its energy output. But what if the snowpack runoff that the hydroelectric project needs to generate electricity is diminished by reduced snowfall, or by regulatory diversion of the runoff for other purposes? A high ESG score in this example would be a misleading indicator away from underlying credit risks. Similarly, a utility that receives a low ESG score because of its proportion of coal-fired electricity may have very low debt, limited state-specific regulatory pressure, and an affordable plan to transition to renewable energy—all of which would be missed by the low ESG score. Such advantages would be captured by an issuer-specific analysis of ESG Management and would likely be drivers of a credit rating.

In other words, regardless of the specific nature of the climate-related risk or opportunity, the nuance relative to some other market participants is that KBRA's integration of climate risk into our credit rating process is one of inquiry and analysis of risk management—not one of subjective judgment or scoring used to derive a stand-alone ESG score.

Cyber Risk

KBRA has frequently integrated analysis of cyber risk management practices into credit ratings. The questions regarding cyber risk that KBRA pursues can vary considerably based on the issuer and the sector but these can sometimes include areas of inquiry such as:

- Does the issuer employ a dedicated person/staff to manage information and/or IT security, such as a chief information security officer?
- Does the issuer follow an internationally accepted security standard such as ISO 27001, SSAE-18 SOC reporting, NIST's Cybersecurity Framework, or CIS Top 20 Controls? If so, which ones and is the organization audited to this standard on a regular basis?
- Does the entity have a security awareness program in place and are employees regularly trained and tested on cybersecurity issues?
- Does the issuer have a security incident response plan and is it regularly tested? Does the issuer have business continuity and disaster recovery plans? Are they regularly tested?

Where relevant, KBRA will incorporate cyber risk analysis into the ESG Management section of its published reports along with other ESG factors.

Stakeholder Preference and Reputation Risk

As mentioned previously, many ESG topics that are integrated into other organization's ESG scores are difficult or impossible to correlate to credit risk. Attempts to customize lists of these factors for different industries often worsens rather than strengthens their relevance to fundamental credit risk analysis by implying a false sense of precision. KBRA does not believe it is the role of rating agencies to subjectively choose which of these credit-irrelevant ESG topics are important for a given issuer or investor, nor how to weight or score them. However, KBRA recognizes that each issuer, regardless of industry or sector, may face pressures from their stakeholders' own ESG preferences. Across the broad landscape of CFG issuers, these stakeholders can include customers, investors, employees, voters, regulators, among others.

Therefore, KBRA believes it is important for issuers to demonstrate awareness of and disclose the ESG preferences of their key stakeholders, and how these preferences may impact the issuer's operating, capital, and financial strategies. As KBRA analysts interact with management teams, one guiding question we might use to initiate inquiry into an issuer's management of stakeholder preferences and related reputational risks is: Do your investors,

customers, employees, regulators, voters, or other key stakeholders have environmental, social, or governance goals or policy preferences that present risks and/or opportunities to your enterprise?

Conclusion

Through these and other questions, and through the lens of ESG Management analysis, KBRA integrates relevant ESG issues into our credit analysis without having to veer into subjective selection, scoring, or weighting of ESG factors that are not directly credit-relevant. As mentioned above, many ESG topics that are integrated into other organization's ESG scores are difficult or impossible to correlate to credit risk. Attempts to customize lists of these factors for different industries often worsens rather than strengthens their relevance to fundamental credit risk analysis by implying a false sense of precision. While ESG scoring rubrics normatively choose and weight certain ESG topics while ignoring others, KBRA's approach allows for the analysis of those topics most relevant to a given issuer—and most impactful to credit.

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