Credit Ratings and ESG Ratings in the European Union

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Abstract

Over time, credit ratings have gained a major role in the financial market, influencing various financial aspects. For businesses, a good credit rating can indicate financial stability to investors, suppliers, and customers. This can increase the business's reputation and bring new opportunities for growth. However, in the current global context, environment, social aspects, as well as governance policies become essential for global decision-making, but also for financial markets. This article aims to present the importance of ESG ratings for companies.

Key words*:* credit rating, CRAs, ESG rating
J.E.L. classification: A10, D81, D84, G10, G20, G30, G41

1. Introduction

This current article aims to present an overview of the importance of the new types of ratings, respectively ESG ratings, compared to the well-known credit ratings issued by rating agencies (CRAs). The most important rating agencies, whose ratings are presented in this article, are S&P (Standard & Poor's), Moody's (Moody's Investor Services) and Fitch (Fitch Ratings). These are also among the oldest agencies, thus having the most experience in issuing ratings. The information regarding the credit ratings issued by the rating agencies presented in this article applies globally and so does the concept of ESG ratings, but the information presented in this article regarding the regulations in the field of ESG ratings are those applicable to the European Union.

2. Theoretical background

Currently, CRAs have a very important role in the financial markets. They assess credit risk of issuers, which can be countries, companies, or others, by analysing the issuer's ability to fulfil all their assumed financial obligations at the appointed time. Credit Ratings also foster the development and smooth functioning of capital markets by providing transparent information and insight to market participants. The analyses performed by the CRAs are based, to the greatest extent, on the financial indicators recorded by an entity that are calculated strictly on the basis of financial information. The importance of CRA is analysed quite a lot in the specialized literature, including by (Bouye and Menville, 2021) which states that the economic role played by rating agencies is an important one because they provide essential information about an issuer's default risk, thus helping the debt market. At the same time, Bozic and Magazzino (2013) mentioned in their study that rating agencies do not provide a firm recommendation for making an investment decision, but rather an opinion about the creditworthiness of the rated entity. Therefore, the ratings issued by the credit rating agencies facilitate investment decisions, influence borrowing costs and increase market transparency, thus remaining an integral part of the global financial system.

Given that, the main asset of any rating agency is credibility (Raimbourg, 2013) it means that the analysis of entities must be performed in a professional manner and with a full understanding of the impact on the financial market.

In order to reflect in a correct manner newly emerging situations in the financial market, agencies can change or update the rating previously offered to an entity to reflect a more appropriate level from the perspective of the concept of financial creditworthiness.

The first appearance of the term ESG is in 2004 when it was included in a UN Global Compact report. ESG has now evolved into a fundamental component of modern investment and corporate strategy. ESG factors are analysed from both a macroeconomic and a microeconomic perspective.

An overview of each pillar of ESG rating for a company (environmental, social, and governance) includes the following factors:

1) *Environmental* pillar: This evaluates a company's impact on the environment, including factors like direct and indirect greenhouse gas emissions, energy efficiency, the firm's overall resiliency against physical climate risks (like climate change, flooding, and fires), waste management, and resource conservation.
2) *Social* pillar: This assesses the way in which the relationship with employees, suppliers, customers and communities is managed in a company. It includes factors such as labour practices, employee health and safety, diversity, and community engagement.
3) *Governance* pillar: This examines a company's leadership (how an organization is led and managed), board structure, shareholder rights, and transparency (what types of internal controls exist to promote transparency and accountability on the part of leadership). It covers issues like executive compensation, board diversity, and business ethics.

Therefore, while credit ratings assess the creditworthiness of companies or financial instruments by providing an opinion on the risk of default of a company, ESG ratings assess the impact on environmental factors, but also on social aspects and governance policies. Both credit ratings and ESG ratings are opinions provided by specialised entities and used by financial institutions and professional investors.

3. Research methodology

In the analysis presented in this paper regarding the two indicators Rating and ESG, the starting point is the consultation of the specialized literature and the research of the current state of knowledge of the topic. It is also important to clarify the meaning of the concepts as well as to identify the fundamental theoretical statements in order to demonstrate the global importance of these studied aspects.

Regarding the exact data presented in this paper, the method used is the comparison method that allows obtaining general conclusions by comparing the representative indicators using tabular spreadsheets contained in the Excel software.

4. Findings

4.1. Regarding Credit Ratings

Understanding the solvency of companies is a crucial element in making business decisions. Investors need to know the probability that the money invested in bonds or loans will be repaid. Companies must quantify the creditworthiness of suppliers, customers, acquisition candidates and competitors.

The traditional measure of credit quality is a corporate rating, such as that produced by S&P, Moody's or Fitch. However, such ratings are only available for the largest companies, not millions of smaller companies. To quantify their creditworthiness, smaller companies are often analysed using alternative methods, namely probability of default (PD) models.

Probability of default is the probability that a borrower will not be able to make repayments as scheduled. Usually, this is evaluated over a determined period of time, in general one year (according to *IFRS 9 – Financial instruments*). It can be applied to a variety of different risk management or credit analysis scenarios. Probability of default depends not only on the borrower's characteristics but also on the economic environment.

Lenders usually want a higher interest rate to compensate for bearing a higher risk of default. Financial measures (such as cash flow relative to debt, revenue or operating margin trends) are common considerations when assessing risk.

The simplest scenario for estimating the cost of debt occurs when a company has long-term bonds in circulation that are widely traded. The market price of the bond along with its coupon and maturity can be used to calculate a yield that is used as the cost of debt. For example, this approach works for a company that has dozens of bonds in circulation, liquid and frequently traded on the secondary market.

Some companies have bonds in circulation that do not trade regularly. Because these companies are usually rated, we can estimate their debt costs using the ratings and associated default spreads. Thus, an A-rated company can be expected to have a cost of debt of about 1.00% higher than the Treasury bond rate, as this is the spread typically paid by AA-rated companies.

The rating system published by Moody's in 1909 is still in force, being a globally accepted standard and is presented in *Table no. 1*. The rating system of the other two important rating agencies is similar to the one used by Moody's, as can be seen in *Table no. 2* below.

Table no. 1 Moody's: Global Long-Term Rating Scale

Rating	Description
Aaa	Obligations rated Aaa are judged to be of the highest quality, subject to the lowest level of credit risk.
Aa	Obligations rated Aa are judged to be of high quality and are subject to very low credit risk.
A	Obligations rated A are judged to be upper-medium grade and are subject to low credit risk.
Baa	Obligations rated Baa are judged to be medium-grade and subject to moderate credit risk and as such may possess certain speculative characteristics.
Ba	Obligations rated Ba are judged to be speculative and are subject to substantial credit risk.
B	Obligations rated B are considered speculative and are subject to high credit risk.
Caa	Obligations rated Caa are judged to be speculative of poor standing and are subject to very high credit risk.
Ca	Obligations rated Ca are highly speculative and are likely in, or very near, default, with some prospect of recovery of principal and interest.
C	Obligations rated C are the lowest rated and are typically in default, with little prospect for recovery of principal or interest.
Note: Moody's appends numerical modifiers 1, 2, and 3 to each generic rating classification from Aa through Caa. The modifier 1 indicates that the obligation ranks in the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates a ranking in the lower end of that generic rating category. Additionally, a "(hyb)" indicator is appended to all ratings of hybrid securities issued by banks, insurers, finance companies, and securities firms.	

Source:
https://www.moodys.com/sites/products/productattachments/ap075378_1_1408_ki.pdf

Table no. 2 Rating Scale "Big Three"

Standard and Poor's	Moody's	Fitch	Linear transformation
AAA	Aaa	AAA	21
AA+	Aa1	AA+	20
AA	Aa2	AA	19
AA-	Aa3	AA-	18
A+	A1	A+	17
A	A2	A	16
A-	A3	A-	15
BBB+	Baa1	BBB+	14
BBB	Baa2	BBB	13
BBB-	Baa3	BBB-	12
BB+	Ba1	BB+	11
BB	Ba2	BB	10
BB-	Ba3	BB-	9
B+	B1	B+	8
B	B2	B	7
B-	B3	B-	6
CCC+	Caa1	CCC+	5
CCC	Caa2	CCC	4
CCC-	Caa3	CCC-	3
CC		CC	2
C		C	2
SD	Ca	DDD	1
D	C	DD	1
		D	1

Source: (Bozic and Magazzino, 2013)

Following the Basel II agreement, credit risk is assessed individually and not at the level of the entire portfolio. For this, the time profile of the exposure, the realistic default rates and the correlations between them are taken into account.

Some of the most important credit risk assessment models, belonging to international agencies, would be the following:

- CreditMetrics (J.P. Morgan), which assesses the credit risk caused by changes in the market value of loans,
- CreditRisk+ (Credit Suisse First Boston), which estimates the probability of going bankrupt based on historical data on bankruptcy events as well as the debt recovery rate,
- The KMV model (Moody's Analytics), which is based on options theory and structural analysis of credit risk and
- CreditPortfolioView (McKinsey), which estimates the risk of bankruptcy according to certain macroeconomic variables (interest rate, exchange rate, unemployment rate, etc).

Not all companies have a rating granted by the CRAs. Many companies are small or do not want to receive a rating, therefore there are enough companies that are not rated based on probability of default. In these cases, there are two other alternatives:

i. To evaluate recent loan history in order to get an idea of the types of default spreads charged by the company and use these borrowings to get a cost of debt.
ii. To estimate a synthetic rating, which is often calculated using financial models that consider various financial metrics and ratios to approximate what an official rating might be.

4.2. Regarding ESG ratings

Globally, ESG is an important indicator and there is an ongoing process of increasing the transparency and accuracy of information in this regard.

The importance of Environmental, Social, and Governance (ESG) factors for investors has grown significantly in recent years, including for ESG-compliant products. Asset managers and institutional investors are increasingly incorporating ESG factors into their investment strategies to meet regulatory requirements and align with the preferences of their clients.

Overall, an ESG framework supports sustainable development while achieving financial goals.

There are various ESG regulations worldwide, but this article presents the main ESG regulations in the European Union as follows:

- SFDR – Sustainable Finance Disclosure Regulation: establishes ESG disclosure requirements for some financial market participants and for asset managers that are mandatory. This regulation aims to increase clarity in order to direct investable capital towards sustainable investments.
- Taxonomy Regulation: establishes the way in which ecologically sustainable economic activities are classified.
- CSRD – Corporate Sustainability Reporting Directive: expands the scope and detail of sustainability reporting requirements for companies, ensuring consistency and comparability of ESG information. This directive mandates that large companies and listed SMEs to report ESG data in a detailed way. The CSRD aims to standardize sustainability reporting across the EU in order to increase transparency and comparability for investors.

In addition to these, regarding the activity of granting an ESG rating, the Commission has published a regulation proposal in order to obtain the transparency and integrity of these rating activities, which can be found on the authentic Official Journal of the EU (EUR-Lex). The proposed regulation aims to improve the quality of information on ESG ratings, but it does not intend to harmonise the methodologies for the calculation of ESG ratings, just to increase their transparency.

According to the draft regulation, an ESG rating provider is a legal entity that provides and distributes ESG ratings on a professional basis and obtains an ESMA (European Securities and Markets Authority) authorization. Also, an ESG rating means an opinion on the impact on people, society and the environment obtained using an established methodology and a well-defined classification system. Therefore, the draft regulation aims to develop a regulatory framework applicable to ESG rating providers and to provide greater transparency on the ratings they issue.

According to World Bank (Baharoglu et al., 2018), good environmental, social and governance practices have become a new normal in doing business, a way to support companies' financial performance and their ability to grow and compete. According to an analysis of 656 companies, those with good environmental and social (E&S) practices outperform those with worse E&S practices on return on equity (ROE).

Also, the idea that a solid ESG indicator can bring value to a business also appears in a McKinsey quarterly report from 2019 (Henisz et al., 2019) where it is stated that there are five links between ESG and value creation which are presented in table no. 3.

Table no. 3 Five links to value creation

	Strong ESG proposition (examples)	**Weak ESG proposition** (examples)
Top-line growth	Attract B2B and B2C customers with more sustainable products Achieve better access to resources through stronger community and government relations	Lose customers through poor sustainability practices (eg, human rights, supply chain) or a perception of unsustainable/unsafe products Lose access to resources (including from operational shutdowns) as a result of poor community and labor relations
Cost reductions	Lower energy consumption Reduce water intake	Generate unnecessary waste and pay correspondingly higher waste-disposal costs Expend more in packaging costs
Regulatory and legal interventions	Achieve greater strategic freedom through deregulation Earn subsidies and government support	Suffer restrictions on advertising and point of sale Incur fines, penalties, and enforcement actions
Productivity uplift	Boost employee motivation Attract talent through greater social credibility	Deal with "social stigma," which restricts talent pool Lose talent as a result of weak purpose
Investment and asset optimization	Enhance investment returns by better allocating capital for the long term (eg, more sustainable plant and equipment) Avoid investments that may not pay off because of longer-term environmental issues	Suffer stranded assets as a result of premature write-downs Fall behind competitors that have invested to be less "energy hungry"

Source: (McKinsey Quarterly, 2019)

According to World Bank (Stewart et al., 2022), the efforts to develop at the sovereign level a reporting framework in the ESG field must be performed together with the development of the activity to implement clear international sustainability standards at the corporate level.

From an investor's perspective, an overview of a country's situation is important in the case of investments that exceed the borders of a state within the European Union, or in the case of investments coming from outside the European Union. It is very possible that investors will also take into account the global situation of the state in which the targeted corporations for making investments are located, respectively the sovereign ESG together with the sovereign rating granted by the CRAs to the respective state (see *Table no. 4* for a sovereign overview). Also (Bouye and Menville, 2021) stated that, in order to measure the viability of the debt but also the exposure to the sovereign risk, it is a good thing that the ESG Ratings are analysed together with the credit ratings.

Table no. 4 Sovereign ESG and Sovereign Rating

ESG, Global score, Indicator		Sovereign Risk (Long Term Rating)			
		EU member state	S & P	Moody s	Fitch
EU member state	Rating		Rating	Rating	Rating
Ireland	100,00	Denmark	AAA	Aaa	AAA
Luxembourg	99,28	Germany	AAA	Aaa	AAA
Denmark	88,95	Luxembourg	AAA	Aaa	AAA
Netherlands	86,60	Sweden	AAA	Aaa	AAA
Austria	86,52	Netherlands	AAA	Aaa	AAA
Sweden	85,57	Austria	AA+	Aa1	AA+
Belgium	84,40	Finland	AA+	Aa1	AA+
Finland	84,36	Belgium	AA	Aa3	AA-
Malta	83,20	France	AA	Aa2	AA-
France	82,92	Ireland	AA	Aa3	AA-
Czechia	81,59	Czechia	AA-	Aa3	AA-
Slovenia	81,30	Estonia	AA-	A1	A+
Italy	79,39	Slovenia	AA-	A3	A
Cyprus	79,05	Latvia	A+	A3	A-
Lithuania	78,87	Lithuania	A+	A2	A
Estonia	78,75	Slovakia	A+	A2	A-
Spain	78,71	Spain	A	Baa1	A-
Portugal	77,42	Malta	A-	A2	A+
Hungary	77,32	Poland	A-	A2	A-
Poland	76,83	Portugal	A-	A3	A-
Slovakia	76,58	Croatia	BBB+	Baa2	BBB+
Romania	75,89	Bulgaria	BBB	Baa1	BBB
Germany	75,79	Cyprus	BBB	Baa2	BBB
Latvia	75,79	Italy	BBB	Baa3	BBB
Croatia	74,44	Greece	BBB-	Ba1	BBB-
Bulgaria	72,41	Romania	BBB-	Baa3	BBB-
Greece	71,19	Hungary	BBB-	Baa2	BBB

Source: Own processing based on data provided by Refinitiv

In Table no. 4, the data presented regarding Sovereign Rating and ESG Global Score Indicator (which represents a statistical grade where 0 is the lowest value and 100 is the highest value) is provided by the Refinitiv database.

5. Conclusions

Credit rating agencies have a very long history and they have reached the point where the rating they offer is essential to the financial markets. However, as a result of major changes in environmental care, ESG evaluations have become very important and they have started to have a major impact on investment decisions. Environmental conditions, social policies, but also those related to governance can provide very important additional information which, combined with financial information, can provide an edifying overview for investors in the actions undertaken by them, but also for other categories of entities/individuals for other various activities.

The purpose of this paper is to present the importance currently gained by ESG ratings, but also to signal the need for the cumulative analysis of the two indicators presented in the present article (credit rating issued by CRAs and ESG rating).

A cumulative analysis is needed taking into consideration that credit ratings, which are traditional financial analysis, can overlook non-financial factors that can significantly influence a company's long-term performance. Companies that manage their ESG risks effectively are often better positioned for long-term success. They are more resilient to environmental changes, social and governance challenges, which can lead to more stable and sustainable financial performance.

Therefore, the purpose of this paper to present the importance of the new ratings, respectively ESG ratings, complementary to the credit ratings issued by the rating agencies, was reached.

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