Credit Rating Agencies and Environmental, Social and Governance Considerations: A Long Road Ahead

Daniel Cash*

Recently, the leading Credit Rating Agencies vowed to embrace the initiative developed by the ‘Principles for Responsible Investment’ organisation to incorporate environmental, social, and governance factors into their ratings in a ‘more systemic way’. In this short note, the focus will be on the reasons for why this initiative is being developed, and some of the potential outcomes. Ultimately, it is suggested that the Big Two rating agencies are incorporating such initiatives in name only, and in actual fact the rest of the industry has been actively developing these principles but have been met with stiff resistance from regulators and the leaders of the oligopoly.

The need to develop a culture of responsible, informed, and long-term credit rating analysis within the upper echelons of the Credit Rating Industry is abundantly clear. Recently, the U.S. Department of Justice (DoJ) concluded its investigations into wrongdoing by the two largest rating agencies, Standard & Poor’s and Moody’s, by agreeing to settle with the two for over $2 billion combined (S&P’s settlement being the larger of the two). The conduct of the two agencies in the creation and continuation of the Financial Crisis has therefore led to concerned onlookers developing initiatives to improve the internal mechanics of the agencies, so that their impact upon the economy, and therefore society, can be improved. One such endeavour is a recent push by the ‘Principles for Responsible Investment’ initiative, hereafter PRI, which since its inception in 2005 has sought to act in the interests of its signatories, the marketplace, and society moreover by incorporating long-term factors (Environmental, Social, and [corporate] governance – hereafter ‘ESG’) into the consciousness of those who pledge to engage with the overriding principles advanced by the initiative. The aim of the PRI in relation to credit rating agencies has been to facilitate the development of discourse between agencies and investors, specifically in relation to the benefits of incorporating such forward-thinking factors into the rating process. So, on the back of this, this note will aim to

* Lecturer in Law, Aston University (d.cash@aston.ac.uk).
2 Principles for Responsible Investment Statement on ESG in Credit Ratings (2016).
understand the aims of the PRI in more detail, but then critically analyse this with respect to the actual nature and displayed conduct of the agencies. The note will then look at some of the more positive aspects of the rating industry, i.e. the work going on outside of the Big Two, and then will unfortunately conclude that the chances of a positive outcome from the PRI’s initiative are low, mainly due to the lack of appetite from those who can really affect a change of culture.

The PRI, which as discussed above attempts to breed a forward-thinking and responsible culture within the marketplace, is based upon six fundamental principles: incorporating ESG issues into investment analysis and decision-making; actively incorporate ESG issues into ownership policies; appropriate disclosure of ESG-based considerations; promote acceptance of the PRI principles within the investment industry; a cohesive approach to implementing the principles, and finally; consistent reporting on activities relating to the principles. Organisationally, the initiative has the backing of the United Nations, both as its founding force and as a continued presence on its Board, although it is keen to stress an independence from the U.N. Its funding comes via the annual membership of its signatories, which is important if it is to cultivate an appearance of impartiality to onlookers who have paid the cost of believing in the moral compass of financial institutions. In terms of its prospective partnership with the top rating agencies, including S&P, Moody’s, and Dagong, the collaborative statement published last year discussed how the agencies are aware that although ‘credit rating agencies must be allowed to maintain full independence in determining which criteria may be material to their ratings’, they do in fact recognise that investors are in need of greater clarity when it comes to how ESG factors are influencing and incorporated into the rating process - as a result the agencies vow to evaluate the extent to which ESG factors are relevant, publish their views transparently, maintain governance and resourcing of the development of ESG incorporation where relevant, and finally participate in industry-wide efforts to develop public disclosure and participate in dialogue with investors regarding the impact of ESG factors. As a statement, read alone, it represents an incredibly important step forward and represents a positive outlook for the future of credit rating agencies’ impact upon society. However, it is extremely important that we do not read this

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4 PRI (n 2).
statement alone, and that whenever we discuss an industry that has performed so poorly - so destructively - as the rating industry has, we must take into account the whole picture, rather than the one that makes for the most positive reading.

In that light, there are a number of aspects to the collaboration between the PRI and the Rating Agencies which deserve attention. Firstly, the development of the collaboration stems from a number of important milestones. It was reported in 2014, in a Fixed-Income conference organised by the PRI, that rating agencies were simply not doing enough to consider ESG issues in their analysis, with one participant, Florian Sommer of Union Investment, rating the agencies on this ESG-basis ‘two or three out of ten’, with Dr Hoepner, an academic fellow at the PRI giving the agencies a score of four out of ten, with the caveat that the issue is more likely to be an issue of transparency rather than a denial of the importance of ESG issues. In response, the Senior Vice-President of Moody’s, Henry Shilling, concurred with Dr Hoepner by saying that the qualitative and quantitative assessments ‘will include governance, environmental, and social risks, as appropriate, even though they may be defined differently and [are not] specifically labelled as such’\(^5\). This progresses the discussion onto the next reason why this collaboration deserves attention, and that is this issue of transparency, something which is plaguing the ‘Big Two’ in particular.

In 2015 S&P were given a 12-month Cease-and-desist order by the Securities and Exchange Commission in the U.S. for consciously disseminating misleading information to investors regarding their methodologies that it used to rate Conduit/Fusion Commercial Mortgage-backed Securities\(^6\). In January 2017, Moody’s admitted to the same practice as part of its settlement with the DoJ, in which it admitted to only focussing upon the qualities of the highest rated elements of a securitised offering, but then informing the public that the same methodology had been applied the whole product – leading to the belief that the products were much safer than they were – this practice has been part-and-parcel of the agency’s

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approach for years before the Crisis\(^7\). With this in mind, it is clear to see why this issue of transparency looms large over the Big Two, but the actual wording of the statement of collaboration does not inspire confidence. The agencies’ statement, of which it is presumed the Big Two had the most influence, is at pains to make clear that the agencies must be free to conduct themselves as they see fit, and that they will take into account ESG factors, but only as far as they deem appropriate – this is not a commitment to the principles of the initiative, which seeks to incorporate the initiative’s aims at the core of decision making. It is suggested here that these claimed commitments by the Big Two are too coincidental – its claims to value the needs of investors and incorporate their positions further into the rating process comes just as its receives record penalties for doing the exact opposite. Whilst an optimist would say this is a required response, the recent history alone suggests that the rating agencies have no interest in promoting the interests of the investor, simply because it does not pay to do so. The conscious and undoubted campaign to act against the investor, both before\(^8\), during, and after the Financial Crisis, should suggest nothing other than the understanding that the rating agencies have no incentive to change – the recent ‘punishments’ of the agencies have confirmed what they already knew – the proceeds of transgressing will far outweigh the penalties; so why would they stop?

Before concluding, it is worth noting that this pro-society sentiment is not lost upon the rating industry, but is only demonstrated by those much lower in the pecking order. For example, a number of rating agencies are preparing to collaborate to promote a different vision for the actual process of producing ratings - the collaboration between Egan-Jones, RusRating and Dagong is being labelled as the Universal Credit Rating Group\(^9\). Also, there are a number of non-profit endeavours which are providing a particularly pro-society outlook, the likes of which can be really important to help promote this sentiment of incorporating forward-looking indicators more decisively into the rating process\(^10\). However, one of the closest


(which is not that close at all, relatively speaking) rivals to the Big Three, Egan-Jones Ratings, provides the best demonstration of why such forward-thinking and responsible indicators will not be present anytime soon. The firm, which promotes its credibility through persisting with the investor-pays model, as opposed to the conflict-ridden issuer-pays model adopted by the Big Three, was in 2012 directly threatened by the SEC for what is called an infraction based upon the fact that the firm’s ratings were ‘not disseminated publically’. This, of course, is not possible if you submit to the investor-pays model because disseminating your information to the public would defeat the purpose. This action by the SEC led a leading academic, Professor Jonathan Macey, to conclude the action demonstrated the SEC’s ‘pure maliciousness’ towards any opposition to the Big Three, which is a discouraging analysis to anyone hoping that the current dominance and dangerous conduct of the oligopoly would be, in any way, reduced as a result of the investigations after the Financial Crisis.

Ultimately, the collaboration between the PRI and the leading credit rating agencies represents two things. Firstly it represents the unwavering faith that influential organisations like the UN have in the ability of the rating agencies to behave accordingly. Such belief continues to nourish the incredibly dangerous narrative that what occurred before and 2007/08 was a ‘one off’, and something which can be relegated easily. Secondly, it represents the start of a ‘charm offensive’ by the agencies so that this narrative is perpetuated even further. What needs to be made clear is that their actions were not a solitary event, or part of an endemic culture that the agencies were simply caught up in – their actions were considered, conscious, and most of all purposeful. Rating agencies knew that they were not performing as they should, and they also knew that that lack of performance would see them compensated greatly by the people who paid them. The top agencies consciously facilitated a financial attack upon society which is still having an effect today – on such aspects as national finances, poverty, and even mortality rates and it is imperative that this is not forgotten.