RISK MANAGEMENT IN ESG RATINGS

NOVEMBER 2022

THE RISK MANAGEMENT GUIDELINES

Crédit Mutuel
Asset Management

The reliability of ESG data is a major issue in risk management. Progress in this area will depend particularly on the quality of the data provided by the suppliers but also on the ability of management companies to analyse them. With this objective, the implementation of the CSRD (*Corporate Sustainability Reporting Directive*) will be a major step forward in the evaluation of companies' non-financial information. In addition, the analysis, interpretation and reliability of available data is already subject to the assimilation of 'ESG material' (regulatory texts, good practices, charters, etc.). Within the Crédit Mutuel Asset Management's Risk Department, our monitoring of non-financial risks is based in particular on an ad hoc control system with the support of employees who are specialised in risk management control. **This first ESG risk statement covers a central topic, the internal ESG rating.**

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SUMMARY

*Together,
listen & act*

INTRODUCTION

The French sustainable investment funds market is experiencing a strong growth. According to the research center Novethic, the market size was 896 billion euros in outstanding, up 94% year on year, with 1,186 investment funds identified. This growth can be explained by the will of savers to have a more sustainable allocation of their savings, and also by the European and French regulation evolution. By way of illustration, the SFDR regulation which entered into force on March 10, 2021 makes it easier to identify investments linked to the concept of sustainability through the Articles 8 & 9 classification of investment funds.

RISK

ASSOCIATED TO ESG RATINGS

The Environmental, Social and Governance (ESG) rating of a given issuer (a company or a state) plays a key role in its possible integration into a sustainable investment fund (Art. 9), or into a fund promoting social or environmental characteristics (Art. 8) according to the SFDR regulations.

Hundreds of data points supplied by specialized data providers are aggregated together thanks to an algorithm that will produce the issuer's ESG rating, which will determine whether or not this issuer can be considered as "sustainable". The absence of score, or an ESG score that is too low results in the issuer's exclusion from the investment universe of Articles 8 & 9 funds.

An observed drift of ESG rating is that it is becoming a compliance requirement, as opposed to a tool supporting the investment decision. Therefore, obtaining an ESG score that allows access to sustainable investment funds becomes a crucial issue. For asset managers, ESG rating systems have a triple objective:

- Meet investors' expectations by offering sustainable investment products
- Comply with regulation, by justifying the sustainability of funds through the ESG scores of the issuers in portfolio
- To have a reliable tool for ESG integration into the fundamental analysis of issuers for better informed investment decisions

THE LIMITS

OF ESG RATINGS

ESG data being supplied by external providers, the construction of ESG ratings may involve some issues for asset managers:

- Data availability: some investment universes (small & mid-caps) may not be well covered by ESG data providers
- Data reliability: among all data points used in ESG scoring, some will be audited data, but also self-declared by issuers without any external verification, estimated by the data provider using its own methodology that may not be transparent, or based upon a subjective assessment of forward looking engagements of the issuer (such as the quality of a GHG reduction strategy for the future)
- The weighting and aggregation process of ESG data to obtain a rating is not standardized and therefore differs from an investor to the other, reflecting subjective choices in the algorithm parameters

For instance, an issuer whose ESG rating is good for a data supplier may obtain a poor rating from another data supplier. While the correlation between credit analysis agencies ratings is approximately 96%, it is down to 49% for ESG data suppliers[1]. As a result, it is not uncommon to find among well rated issuers fossil energy, cigarettes, plastics, cement, automotive or unhealthy food producers.

Finally, we note that issuers providing the most information generally obtain a better rating. This favors issuers that have the financial means to focus on ESG data, or that counterbalance the environmental damage caused by their activity by promoting good social and/or governance practices.

1. SOURCE
Notations ESG : de la poudre aux yeux ?
L. Kersterton, 04/2020, **www.allnews.ch**

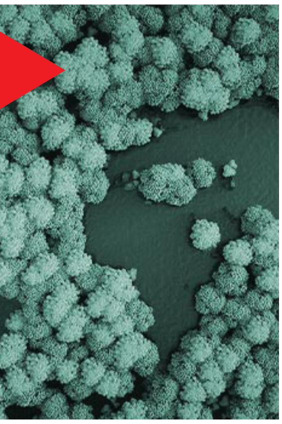
HOW TO

MANAGE ESG RATING RISKS?

The difficulties identified in the ESG rating process highlight risks that require monitoring.

- **Regulatory risk:** advertising an investment fund as sustainable without being able to demonstrate the sustainability of issuers in portfolio
- **Commercial risk:** being unable to offer sustainable funds due to a lack of ESG coverage in investment universes
- **Operational risk:** having an unstable, or too sensitive ESG rating model when anomalies occur in the rating process
- **Reputational risk:** including issuers with a high ESG-washing potential into sustainable funds
- **Financial risk:** biasing the fundamental analysis performed, leading to misinformed investment decisions that do not reflect ESG risks and opportunities

The regulatory risk stems from the lack of ESG data on issuers' investment universes. while the selection of an ESG data provider adapted to the objectives of the asset management is a prerequisite, the monitoring efforts will focus on the ESG-rated issuers ratio at the investment universe level, and within each portfolio. This control also makes it possible to hedge against the commercial risk arising from the lack of ESG coverage of the investment universe.



The operational risk is linked to the rating model developed: the aim is to ensure that for each stage of the scoring process, the model is able to produce consistent ESG ratings, including under abnormal conditions such as the lack of provider data. The control will therefore test and validate the consistency of the results produced by the scoring model in various scenarios.

Reputational risk is difficult to apprehend: beyond controversy monitoring, different types of controls can nevertheless contribute to reduce this risk. From a quantitative angle, the aim is to control excessive ESG score differences for the same issuer between several ESG data providers, which involves to have more than one provider. At issuer level, it is relevant to check that the ESG rating is obtained using a majority of quantitative data points linked to the issuer's past accomplishments rather than qualitative indicators on the existence of future – non-binding - policies and objectives.

Finally, a qualitative control on highly rated issuers supports the identification of issuers that report on a lot ESG data points because they have the means to do so, or to counterbalance a poor E, S, or G performance on a specific topic.

Beyond the regulatory aspect, these controls contribute to strengthen the fundamental analysis by the integration of ESG risks and opportunities. This means a better understanding of the companies in which we invest for a more sustainable world.

Find out more at:
www.creditmutuel-am.eu

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Asset management company of Crédit Mutuel Alliance Fédérale
Public limited company with a capital of €3,871,680
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NOVEMBER 2022

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