ESG INTEGRATION IN THE CREDIT ANALYSIS

PREMISE

The most sustainable companies that achieve the best **ESG** rating are also the most solid and connected to lower credit risk, therefore lower probability of default. This phenomenon was discovered by credit rating agency **Cerved** specialized in assessing the creditworthiness of non-financial Italian companies and their debt securities. Cerved agency conducted detailed analysis including over 3 million datapoint to find a link between sustainability and credit risk.

Cerved classified companies based on the size and found that in each category companies with higher ESG rating are less inclined to default. To be more precise, medium, and large size Italian corporations confirm negative correlation between ESG rating and credit risk. The most sustainable companies have 0.87% probability of default while the companies with worst rating show 3.07%. The same trend appears in group of SME where the spread differentiates between 1,5% to 7.25%. Cerved also found that companies with better ESG rating in 2021 are not only the least risky in 2021 but also recorded improvement in credit rating.

ESG INTEGRATION INTO CREDIT RISK

Incorporation of ESG factor into **credit analysis** is mainly supported by EU organizations to mitigate destructive impact on the environment. Since 2019 **ESMA** together with **EBA** and **EU Commission** published several regulations on how to integrate ESG in credit rating.

Cerved wondered which of 3 E-S-G factors higher influence

credit rating considering the most frequent reasons.

Environmental:

1. Energy efficiency
2. Net zero CO2 tasks
3. Environmental policy

Social:

1. Human resources
2. Training
3. Welfare

Governance:

1. Bad events regarding shareholder or management
2. Organizational model
3. Disclosure and monitoring of ESG factors

Cerved found out that out of three E-S-G factors, the governance factor is the one with the biggest impact on the rating. After integrating ESG into credit analysis, out of 45.98% confirmed valuations only 12.64% recorded upgrade in the rating, while more than 20% recorded 2+ classes downgrade.

Now after examination of the impact of ESG on credit rating, there is a need to analyse the support of EU towards sustainable transition. EU set up a classification system called taxonomy common at EU level, to guide companies towards low carbon economy. The taxonomy is not inclusive to entire Italian industry, although regulatory changes are foreseen. According to Cerved research only 25,8% companies with turnover over € 1 092 billion are considered eligible under EU regulations. The rest 74,2% with turnover € 1 997 billion are not eligible. On average 66% of activities carrying out by eligible Companies are sustainable.

EFFECTS OF THE GREEN TRANSITION ON CREDIT RISK

Cerved also looked at how green transition impact the credit risk of Italian companies. From the analysis it is possible to foresee different effects for industrial sectors. There are three sectors recognized. Leaders who are offering sustainable services, chaser who are mostly in the field of agriculture, road transport and waste management and laggards whose businesses contaminate the environment at the highest level. In the long term the competitive advantage of leaders will become extremely strong in term of credit risk, while the probability of default of less sustainable companies will increase.



Source: Cerved

GLOBAL VALUE CHAIN

Cerved examined the analysis of **global value chain**. In the past decades global value chain has been bringing many advantages for business like reduction of cost or greater diversification. Large number of advantages also takes problems that GVC must face. Climate change is one of the biggest one, therefore there is a need to monitor impact of GVC on the environment. There are three categories of emission, where two of them are connected directly to companies while Scope 3 category includes indirect emissions from sources. Because of the significant impact of scope 3 on the companies, its monitoring and reporting is important to understand overall carbon footprint of the companies. Cerved found that only 45% Italian and 55% worldwide companies include information about Scope 3 in their non-financial analysis. In addition, only 23% companies reveal presence of upstream/downstream decomposition.

Finally, Cerved created ESG risk heatmap to identify sectors within the GVC most inclined to the risk, including building material, chemicals, and textiles, and highlights the need for company screening. In fact, according to the survey 88% of companies do ESG screening and only 40% of these companies use detailed approach that measure performance. Results conducted by Cerved show that there is no longer possible to separate the goals of economic growth from the goals of sustainability and this is the real challenge for all stakeholders.

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