Insights from Fitch's Inaugural ESG Ratings

Entity and Framework Score Gap Means 'Brown' Companies Can Still Meet Green Standards for Bonds

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>
> Nneka Chike-Obi, ESG Research, Sustainable Fitch

Sustainable Fitch's ESG Ratings provide a quantitative and qualitative assessment of the impact an issuing entity and associated financial instruments have on the environment and society. We assign ESG Ratings to individual entities, to Green, Social and Sustainable (GSS) and sustainability-linked debt instruments, (collectively referred to as "labelled instruments") as well as to non-labelled instruments.

ESG Ratings derive from an analysis of actions, outcomes, impacts and activities, in addition to policies and broader commitments.

Frameworks Score Higher than Entities

The introductory cohort of 220 entities assigned ESG Ratings by Sustainable Fitch has an average framework score of 74 and an average entity score of 58, on a scale of 0-100. This indicates that issuers of labelled bonds are doing a good job at aligning their ESG labelled bonds to international best practice, but their business activities only have average sustainability performance.

Green bonds are the largest subset of labelled bonds in our dataset (476) and have the highest framework scores, achieving an average of 76. Use of proceeds instruments overall received better scores than sustainability-linked bonds, which ranked at the bottom of the four labelled bond categories.

EMEA Top for Regional Averages

Entities from EMEA have an average ESG score of 60, showing slightly better sustainability profiles than those in Asia-Pacific and the Americas. European entities make up both a large share of the total dataset and represent most of those from EMEA due to the longer history of ESG-focused regulation in the EU than in other regions.

Issuers in Essential Services Have Most ESG-Aligned Business Activities

Public entities, all involved in affordable or social housing, have the highest average scores for business activities, which evaluates the environmental and social impacts from core operations. Airports have the lowest average business activities scores, driven by the environmental impacts of their customers consuming fossil-based aviation fuel.

Sustainable Fitch's ESG Ratings are in-depth analyses of individual entities and bond frameworks against a common methodology. Aggregating results and considering insights on a higher level – either by sector or geography –does therefore inevitably include some generalisations that may not apply to each individual case. However, we believe that looking at ESG Ratings on an aggregate level that enable a cross-comparison of sector and regional trends as they pertain to environmental or social impacts yields valuable, contextual insights for investors.

Related Research

Introduction to ESG Entity Ratings (March 2022)
Introduction to ESG Framework Ratings (May 2022)

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Methodology

We assign ESG Ratings to individual entities, labelled instruments and non-labelled instruments. These include secured and unsecured debt issued by entities.

The ESG Ratings that we assign are:

- ESG Entity Rating (ESG.ER) for individual entities;
- ESG Framework Rating (ESG.FR) for debt instruments; and
- ESG Instrument Rating (ESG.IR), derived by combining the ESG.ER and ESG.FR.

They provide a quantitative assessment of the impact an issuing entity and associated financial instruments have on the environment and society. These ratings correspond to a range of underlying scores from 0-100, where a higher score indicates a better rating (see panel on the right for more detail).

The ESG.ER indicates an entity's performance, commitment and integration of environmental or social considerations into its business, strategy and management, as well as the effectiveness of governance.

The ESG.FR measures the strength of a particular GSS or sustainability-linked bond framework, which can be assessed individually or in conjunction with that of the entity.

ESG.IR integrates the previous ratings, providing additional context to ESG.FR and allowing for an absolute comparison of financing instruments across sectors, geographies and labelling frameworks.

Sustainable Fitch ESG Ratings

Fitch evaluates entities, frameworks and instruments, and assigns scores on a 0-100 scale. These equate to overall ESG ratings from 1-5, where '1' is the best rating and '5' the worst. The below definitions apply as following:

Entity: Assessment both in terms of alignment of the activities with taxonomies of reference and integration of ESG considerations into the business, strategy and management.

Framework: Assessment in terms of alignment with ambitious best practices, and how proceeds are dedicated to environmental or social activities/projects according to taxonomies of reference.

Instrument: A weighted average of entity and framework ratings.

ESG Rating Scale

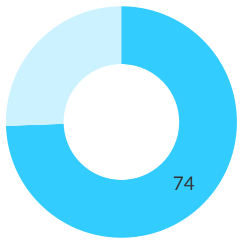
Rating	Score	Assessment
1	87.5-100	Excellent; fully ESG aligned
2	62.5-87.4	Good; mostly ESG aligned
3	37.5-62.4	Average; neutral
4	12.5-37.4	Sub-Average; mostly ESG unaligned
5	0 -12.4	Poor; ESG unaligned

Source: Sustainable Fitch

Frameworks Outperform Entities in ESG Ratings

Fitch has rated around 220 entities and 640 bond frameworks. The average ESG.FR is 1.94 with a score of 74, compared with 2.68 and score of 56 for ESG.ER. This indicates that labelled bond frameworks have a better sustainability profile and are more aligned to international best practices than the issuing entities do themselves. This is because a company whose core business activities may be harmful to the environment or society can still issue a best-in-class labelled bond with proceeds financing green or socially beneficial activities. In some cases, this is part of a corporate transition strategy, where a high-quality green or socially positive project is a key part of an overall improvement in the entity's sustainability profile.

Average Framework Score



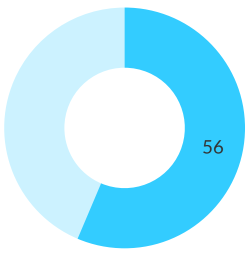
Source: Sustainable Fitch

Companies with the best sustainable financing frameworks include several European power companies with large renewable energy portfolios, an auto manufacturer and a global pharmaceutical manufacturer. Both green and sustainability use of proceeds bonds are included in this group of top-performing frameworks, primarily financing assets with high-quality green credentials. The top framework achieved a score of 94 which equates to an ESG.FR of '1.'

The lowest-rated frameworks include companies in a range of sectors, such as transportation, agriculture, banks and real estate. Lack of project selection criteria, a lack of information on how proceeds will be segregated and managed, and the inclusion of large amounts of working capital or operating expenditures are factors that can contribute to a poorer framework rating. The lowest assigned framework score in the dataset is 33 with a ESG.FR of '4' indicating sub-average performance.

In this initial dataset, the sector with the highest average framework score is power utilities and electricity providers; food, beverage and tobacco have the lowest average framework scores.

Average Entity Score



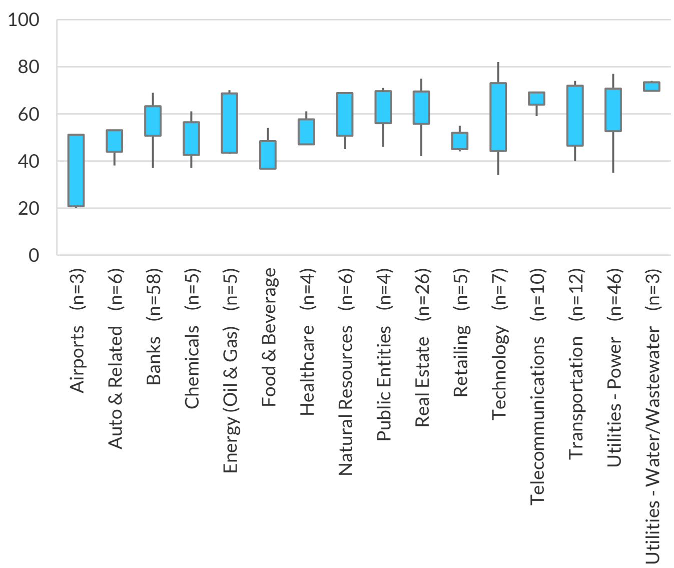
Source: Sustainable Fitch

There are no entities with scores high enough to achieve an ESG.ER of '1.' The highest aggregate entity score in this cohort is 82 and an ESG.ER of '2' indicating good overall sustainability performance. Many entities with scores above 70 are involved in renewable energy and water/wastewater management. Other sectors represented among the top-rated entities include low-carbon transportation and infrastructure, and real estate focusing on green and energy-efficient buildings.

Entities with a score below 37.5 have an ESG.ER of '4' indicating sub-average sustainability performance. This includes companies in the technology, transportation, banking, and natural resources sectors. Carbon-intensive activities where abatement is difficult, such as air transportation, logistics, and commercial agriculture can contribute to a poorer rating. Lack of sustainability disclosures or policies is another factor related to score performance. The lowest entity score in the dataset is 20.

On a sector level, water and wastewater utilities have the highest average entity scores and airports have the lowest.

Sector View: ESG Entity Scores (Selected)

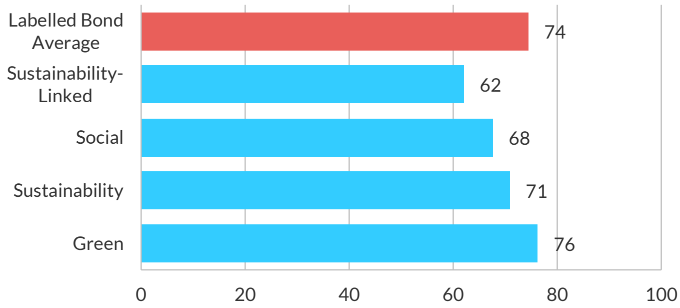


Source: Sustainable Fitch

Highest Average Scores for Green Bond Frameworks

Sustainable Fitch has evaluated around 640 debt instruments, of which 614 are ESG-labelled bonds. For these bonds, the ESG.FR represents how well they align to international best practices in five categories for use of proceeds frameworks and three categories for KPI-linked frameworks.

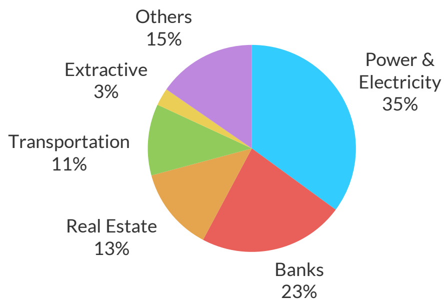
Framework Scores by Bond Type



Source: Sustainable Fitch

Green bonds, which are use of proceeds instruments that finance environmentally positive activities and projects, have the highest average framework score of 76. They also make up the largest share of the cohort accounting for around 470 of the total frameworks rated to date. Sustainability bonds, a use of proceeds format for financing both environmentally and socially positive activities, have an average score of 71. These can be achieved either by a use of proceeds that is both green and socially beneficial (e.g. low-carbon transportation), or through a framework with a mix of activities, some with green objectives and some with social objectives.

Rated Green Bond Frameworks by Sector



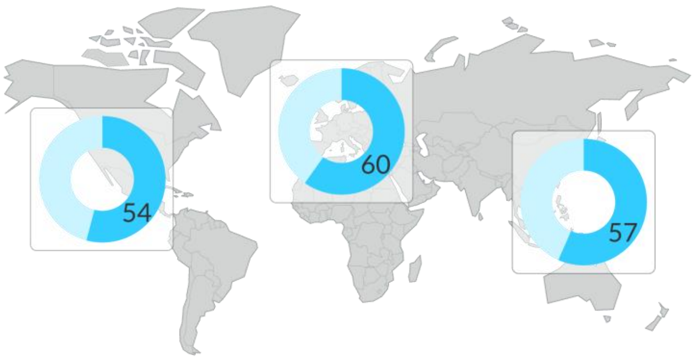
Source: Sustainable Fitch

About a third of the rated green bonds are from the power sector, with the vast majority financing renewable or low-carbon energy generation and distribution. Just under a quarter of green bonds were issued by banks, which typically use proceeds to increase their share of green lending and financing activity.

Europe Top Region for Ratings and Issuance

On a regional basis, EMEA issuers have the highest average entity score of 60 compare to the global average of 58. Scores in Asia-Pacific and the Americas are only slightly lower at 57 and 54, respectively, and all are equivalent to an ESG.ER of '3.'

Average ESG Entity Scores by Region

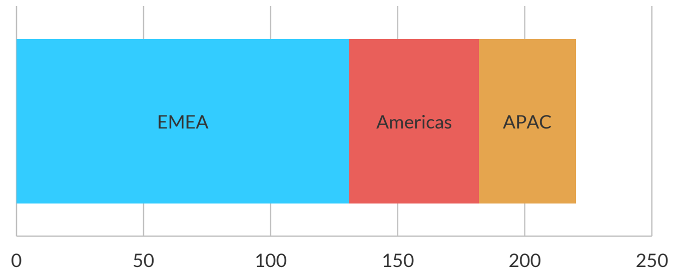


Source: Sustainable Fitch

EMEA entities also make up the largest share of issuers in the dataset accounting for 60% of the total. The regulatory environment in Europe is highly supportive of sustainability in business and financing activities, and both the EU and national governments in the region have introduced legislation aimed at developing greener and more socially responsible economies. The regional differences is most noticeable in the power sector, where the long-established EU Emissions Trading Scheme has established market-based incentives for companies to reduce the share of fossil fuels in their energy mix.

ESG Rated Entities by Region

Number of entities (N=220)



Source: Sustainable Fitch

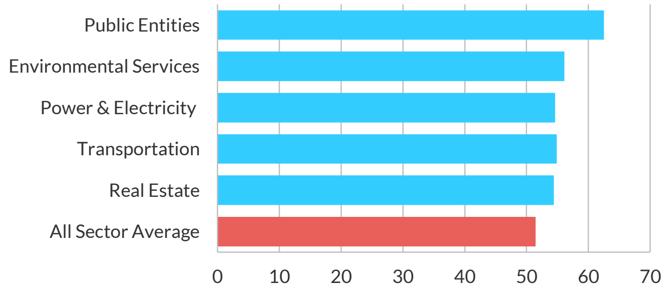
Highest Business Activities Scores for Entities Providing Essential Services

Fitch considers business activities a key factor in evaluating an entity's sustainability profile, and the score in this category accounts for 45% of the overall ESG.ER. This is an analysis of the environmental and social impacts of an entity's core operations and their alignment to international standards and science-based taxonomies, among other benchmarks.

All the sectors with the best scores for business activities include entities that provide basic and essential services such as power, housing, transportation, and sanitation. While renewable energy companies tend to have the strongest environmental sub-scores, they do not perform as well in the social aspect. Entities that provide affordable services that benefit large portions of society are more likely to achieve a high social sub-score.

ESG.ER Business Activities Scores

Top 5 Sectors and Average



Source: Sustainable Fitch

The food, beverage & tobacco sector has the lowest average business activities score (39) and lowest environmental sub-score (31). This is due to the large contribution to greenhouse gas emissions, deforestation, land use change and water resource pressure by commercial agriculture.