



UNEP Finance Initiatives
Innovative financing for sustainability



Rating Roundtable Summary Report

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UNEP FI Ratings Roundtable

“Risk on Trial: The Changing Face of Non-Quantitative Risk”

Representatives from various rating agencies came together in Paris on January 8, 2003 to discuss the issue of non-financial (sustainability/ qualitative) risk and its implications for the rating industry. This group of senior executives representing credit, equity, governance, environmental and ethical rating agencies were joined by regulators to provide their perspectives on the topic and the perceived impact on their industry. The meeting engaged participants in constructive and much-needed dialogue to advance the debate over the future landscape of rating assessment. This report, a summary of the proceedings of the meeting which was conducted under Chatham House Rules, is intended to serve as the basis for future work in this area.

Introduction

Opinions on the creditworthiness of issuers of securities and other financial obligations play a critical role in the investment decisions of both investors and the availability of capital to companies. Recent scandals have placed greater scrutiny on how and why company ratings are being conducted. Assessments by rating agencies define a globally uniform benchmark, and therefore are attractive as a reference for international regulatory standards to cope with the risk in increasingly interconnected financial markets. The questions arising from this observation with relation to sustainability issues are how are rating agencies evaluating the non-financial side of risk, and given the rapidly changing nature of material business risk, how should non-financial risk be assessed in the future by rating agencies?

Materiality of Non-Financial Risks

The focal point of the discussion was centred on whether non-financial risks constitute a present and material threat to financial performance. An important condition for this, according to mainstream agencies, was the nature, timing and the impact of these risks. Raters laid out the importance of time horizons and the sector specific relevance of these risks. If risks are long term, they generally do not tend to be factored into mainstream ratings that assess default risk over a limited period and short-term performance. Additionally, these risks may not have the same impact across different sectors. Reputational risks may affect certain industries with greater exposure to these risks more than others. Therefore, the immediacy of risk and sector specification is a factor in considering non-qualitative risks on an assessment.

It was made clear from mainstream raters that non-financial risk should only be assessed when the business case is satisfied and can be quantified as material to the companies default risk or market performance. Mainstream parties claimed that only those non-financial risks with immediate financial implications were material to gauging default risk and equity performance, and that these particular risks are currently being assessed where they overlap with financial risks. For instance, mainstream agencies will look at a company’s exposure to legal liability and reputational damage. These specific non-financial risks are one reason that the tobacco industry has lower ratings than may be financially reflected. Other risks, such as corporate governance,

were argued not to be an inherent element of accurately assessing company risk. Good corporate governance may be a subset of good financial performance, however companies with poor financial performance may also have good corporate governance. The difficulty of governance assessment is compounded by the need to quantify the metrics used. One participant cautioned that ratings should not be impacted by non-financial risks that were in essence 'value judgements' and not inherent to the material risk of the company being rated.

Non-traditional raters countered that non-financial risk is a misnomer; rather that risks of a primarily non-financial nature have, or will have, a material business impact. They argued that non-financial risks are increasingly becoming relevant to the bottom line and should be assessed in anticipation of their materiality. Insight from mainstream ratings in emerging countries supported this case by detailing the assessment of companies' ability to respond to regulatory changes in countries where policy risk can be a significant factor. It was also asserted that methods exist to assess this risk through an examination of credit spreads and quantifying carbon tax impositions. Examples such as the immediate impact of customer boycotts, "green taxes", and the financial impacts created through governance risks such as Enron reinforced the case for assessing the financial impacts of these costs.

Despite these arguments, the mainstream agencies maintained that non-financial ratings and credit/equity ratings should remain separated, while the general consensus from non-traditional raters was clearly that non-financial risk were inherent in a true assessment of risk. One of the issues that both groups of raters felt needed to be addressed was the quality of information available to make assessments. In supporting this point, one participant stated that moving forward on non-financial risk required tools, such as the Global Reporting Initiative that provide standardized measures, to be properly employed and uniformly applied. It was agreed that there is a need for the same set of rules to allow for comparison across sectors.

The focus shifted into a discussion over reputation risks and the immediacy of their impact. A key point raised was the fact that reputation risk is often short lived (the example of the Exxon disaster was cited), suggesting that it holds little relevance in the long term with regards to a company's ability to meet its obligations. Enron and the current bear market were discussed at length as examples of non-financial risks becoming material to ratings. This was countered by mainstream raters, who claimed that Enron was a case of company fraud and therefore falls outside the mandate of the agencies and that defaults in the current bear market were in line with rates projected by the ratings.

Corporate Governance

Another phase of discussion addressed the role of corporate governance and corporate social responsibility in the rating process and how the rating agencies can contribute to this multi-stakeholder dialogue. It was stated that corporate governance issues are easier to quantify than corporate social responsibility issues, and therefore make them an ideal first line of inquiry.

Reference was made to various studies that demonstrated a lack of understanding by the board on operational issues, as well as highlighting the potential for exposure. Statistics cited included 30% of companies having been sued, 40% having no access to D&O insurance, and 70% of CEO's not understanding the role of the Chief Risk Officer, demonstrating the widespread nature of corporate governance issues with implications for financial risk assessment. This lack of understanding has the potential to cause organisation problems and financially impact the business. Rating agencies can therefore emphasize these issues and play a role in moving this to the Chief Financial Officer's desk.

In order to strengthen corporate governance in the markets, it was proposed that the level of board independence, financial transparency, and structural governance, together with providing a new framework for regulators, needed to be examined. A contrary view was offered that corporate governance may not be relevant to the primary goals of the rating agencies. Corporate governance metrics may identify management issues, but good corporate governance does not necessarily equate financial performance and may not impact the short-term nature of the ratings.

Regulation and Industry Governance

Participants discussed the impact and materiality of the growing move towards regulation and re-regulation, evidenced by recent developments such as Sarbanes-Oxley in the US, the Association of British Insurers guidelines, and new listing requirements. Current UK listing requirements that refer to a disclosure of all "material business risk" were a particular area of interest for attendees. As "material business risk" is currently undefined, a definition that includes disclosure material sustainability risks could create a market demand for non-financial risk based assessment. This proposition was countered by the claim that defining the disclosure may result in diluting the legislation by narrowing the scope on over which it can be applied; instead raters should focus on how government revenue shifts from 'good' to 'bad' companies are making non-financial risks 'real' costs.

The internal governance of the ratings industry was also brought into question. As rating agencies are financed via the very firms that they assess, conflicts of interest of an Andersen/Enron nature could exist. Raters countered questions regarding potential conflicts of interest by stating that this would not benefit the rating agencies as inaccurate ratings would effectively dilute their brand, namely their reputation, which acts as an efficient internal regulator. Due to a market demand for ratings methodology, the information is made available and raters differentiate themselves through interpretations and weighting of the criteria. To avoid illicit relationships between companies and analysts, mainstream analysts must present to broader committees before in order to determine a rating, depending on the importance of the rating/company. The general consensus among agencies was that self-regulation works. Regulators noted the political pressure in some quarters to regulate rating agencies, but also considered it important to concentrate on raising awareness on the issues surrounding non-financial risk.

Although it has been proposed in the regulatory community to give rating agencies oversight powers over auditors to effectively ensure accurate risk

assessments, raters were discontent with having their industry act as the front line for governance of companies given the changing dynamics of the financial architectures. The statement was made that rating agencies are not auditors and should not be asked to “audit the auditors”. Several agencies spoke of the increased scope and complexity of companies that has already complicated their core business. To manage and assess corporate governance risks in new companies with new financial engineering structures while avoiding potential issues, raters have already had to strengthen their due diligence through engaging specialist teams to assess the financial engineering by employing CPA’s, off balance sheet experts, and forensic accountants.

Summary

For risks to become relevant in mainstream ratings, the case must be built that non-financial risks are in fact material to business. One of the difficulties in presenting the case for materiality of non-financial risk is the difficulty in quantifying and distinguishing the distinct impacts on credit and stock performance. Additional obstacles include the immediacy of the risk and the magnitude of sectorial exposure to such risk. However, if a market demand is generated, or the link between non-financial risk and financial impact receives buy-in from the market, either through regulation or by companies looking to capitalize on their responses to a reduction of risk, raters will be driven to incorporate this issue.

The bottom line is that financial systems have changed over the longest bull market of the 20th century and it is only given the current downturn that the ratings agencies have been responding to these changes. Anticipation of developments regarding non-financial risk in the current bear market may be critical in defending the reputation of individual rating agencies and accurately assessing company liabilities.

Key Recommendations

- A majority of roundtable participants indicated a desire to continue in a well defined dialogue, with scope to engage in specific project-based activities if required, and that UNEP FI was the appropriate convening body.
- It was proposed that a valuable tool in contributing to the debate and quantifying non-financial costs would be to establish a series of models that could provide stress testing of liquidity from various environmental and social impacts.
- A working definition on non-financial risk should be established to further this discussion.
- There is a need to consolidate the various environmental and sustainability reporting and indicator initiatives around one, universal and internationally accepted benchmark or standard. UNEP FI and GRI are well placed to take this process forward and a meeting should be convened at the earliest opportunity to bring the interested parties together. Ultimately, the agreed standard would provide the key information source – for raters, analysts, and other interested market players - on the sustainability approach and reported progress of financial institutions globally.

Next Steps

Next steps from the January 8 meeting could include, inter alia, the following:

- With recent shocks such as the adjustment of AIG's corporate rating due to increased liabilities arising from non-financial issues, UNEP FI proposes the establishment of a consultation group to advise signatories and the unit on the changes that are ongoing in the assessment of non-financial risk.
- UNEP FI proposes to develop a working group to explore a mechanism for stress testing liquidity rates of companies exposed to potential environmental and social shocks.
- UNEP FI will attempt to engage stock exchanges and institutional investors in the debate to evaluate their commitment to non-financial issues and anticipate changes in the regulatory environment that can make non-financial risks material. UNEP FI will work with appropriate partners, such as ASrIA in the case of Asia-Pacific, to further this work.
- Due to UNEP FI's involvement in the process, it is proposed that non-financial risk be defined as environmental and social risks for ongoing discussion.

Attendees

1. Jacqueline Aloisi de Larderal, Assistant Executive Director and Director, Division of Technology, Industry and Economics, United Nations Environment Programme
2. Alan Banks, Chief Executive Officer, Core Ratings
3. Paul Clements-Hunt, Head - UNEP Finance Initiatives, United Nations Environment Programme
4. Xavier Chavee, Director and Credit Officer – Europe, Standard and Poor's
5. Agnes de Pitigny, Managing Director, Standard and Poor's France
6. Jean-Renaud d'Elissagaray, Marketing Director, Vigeo
7. Alois Flatz, Head of Research, Sustainable Asset Management Group
8. Michael Foley, Senior Managing Director – EMEA, Moody's Investors Services
9. Yuki Kakiba, Junior Professional Officer, UNEP Finance Initiatives
10. Philip Moss, Internal Advisor, UNEP Finance Initiatives
11. Danièle Nouy, Secretary-General, Basel Committee on Banking Supervision
12. Brian Pearce, Centre for Sustainable Investment, Forum for the Future
13. Herwig Peeters, Executive Director, Ethibel
14. R. Ravimonhan, Managing Director and CEO, Credit Rating and Investment Services of India Limited
15. Dirk Reinhard, Representative, Insurance Industry Initiative
16. Jose Sanchez-Crespo, General Manager, A.M. Best Europe Limited
17. Simon Thomas, Chairman, Trucost plc
18. Pierre Trevet, Managing Director – France, Innovest
19. Thomas Wels, Partner – Zurich and Athens, McKinsey and Company
20. Mark Wharton, Manager, FSA

Background Documents

UNEP Finance Initiatives, "0.618 - Special Edition on Corporate Governance", January 2003 (<http://www.unepfi.net/0.618/>)

Dr. Steven L. Schwarcz, "Private Ordering of Public Markets: The Rating Agency Paradox", University of Illinois Law Review, Number 1, Volume 2002 (http://home.law.uiuc.edu/lrev/publications/2000s/2002/2002_1/schwarcz.html)

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