Commentary

Climate-Related ESG Factors : Reviewing the Relevance and Significance

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Overview

In this commentary, we review how credit ratings or credit rating trends of Corporates, Governments, Structured Finance vehicles (SF), and Financial Institutions (FIG) rated by DBRS Morningstar have been influenced by Environmental factors as outlined under the DBRS Morningstar's ESG Criteria.

Within DBRS Morningstar's ESG framework, climate and climate change considerations can be found in several ESG factors. Social and Governance factors can have a climate angle, however, none of the Social or Governance factors within our rating universe have had any credit impact based on climate-related considerations in 2022. As a result, in this commentary, we solely focus on the Environmental factor. For a more detailed view on climate risk and the potential impact on our credit analysis, see the commentary titled "ESG: Climate Risk and Credit", published on May 2, 2023.

Climate factors currently have a marginal impact on credit ratings within DBRS Morningstar's rating coverage. However, this review shows that some sectors within our coverage are more negatively (and sometimes more positively) impacted than others by the transition towards a less carbon intensive society. Looking ahead, it is likely we will see an increase in credit relevant Environmental factors in some Corporate sectors if issuers are slower to adapt to regulatory changes or have not adequately transitioned to net zero emission. Meanwhile, the potential credit impact of physical climate risks will continue to be closely monitored, particularly in the P&C Insurance sector and property-related sectors.

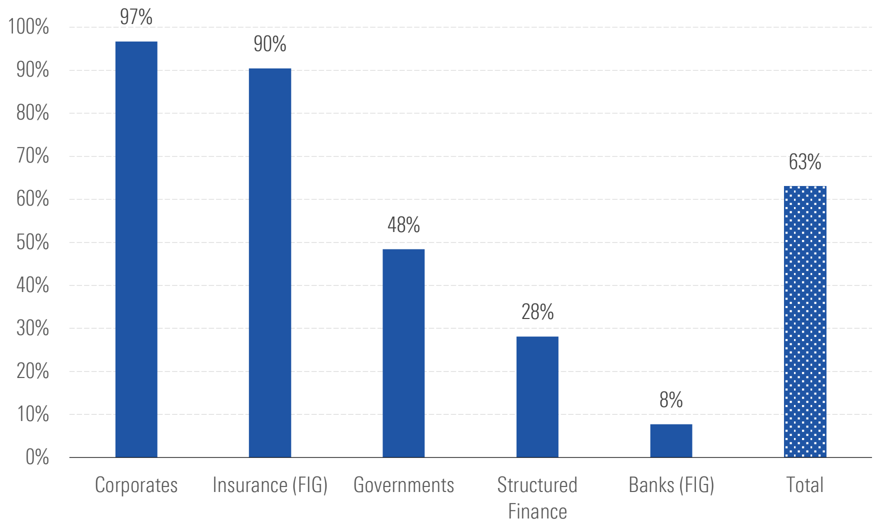
Climate-Related ESG Factors: Closely Monitored

In DBRS Morningstar's ESG framework, we have five Environmental sub factors, although certain Environmental sub factors are not always considered climate-related. Nevertheless, in 2022, we estimate that climate change considerations represented approximately 90% of the Environmental considerations assessed as relevant or significant in the credit analysis.

A 'relevant' ESG factor means that the impact of the applicable ESG factor has not changed the rating or rating trend of the issuer, however, the identified factor affected the credit analysis.

When a factor or a combination of factors is seen as 'significant' to the rating, it means that the impact of the applicable ESG factor(s) has changed the rating or trend on the issuer. If the considered factor(s) did not exist, the rating would be different. In addition, although a relevant factor may not be impactful enough in and of itself to change a rating or trend, it is possible that several relevant factors, when present in a particular issuer's credit risk profile, may have the combined effect of a significant factor or may be impactful enough to change a rating or trend.

Exhibit 1 Relevant Environmental Factors as % of Total Rating Actions With Relevant ESG Factors in 2022



Source: DBRS Morningstar.

Exhibit 1 shows the number of relevant environmental factors as a percentage of rating actions where there was a relevant Environmental, Social, or Governance factor(s) in 2022. Therefore the scope of this analysis only covers instances when an ESG factor was viewed as relevant in our analysis, not all our rating actions.

On that basis, we find that if an ESG factor was present in the analysis, it was most often Environmental considerations within Corporates in sectors such as autos, oil & gas, mining, utilities, infrastructure, and aviation, often due to the Carbon and GHG Costs sub-factor (due to the transitional climate risk considerations). In contrast, Social or Environmental considerations were less likely to be relevant in Corporates.

This predominance of Environmental considerations being the relevant ESG factor (if any) in Corporates is closely followed by the Insurance sector (FIG). In the Insurance sector, Property & Casualty (P&C) insurers have the greatest exposure to climate change. While it depends on the nature of the business P&C insurers underwrite, more than half of the P&C insurers we rate were exposed to increased weather-related losses from natural catastrophic events such as storms, wildfire, and other extreme weather (physical climate risk).

In Governments, relevant Environmental ESG factors most often reflect countries that rely on fossil fuel exports (or imports) or other commodities. These risks are not necessarily driven by climate change, but climate change could potentially exacerbate a sovereign's vulnerability to commodity shocks. Climate and weather risks are generally greater for small island economies and less developed countries dependent on agricultural commodity exports.

In Structured Finance, relevant Environmental ESG factors were below our average, often reflecting energy efficiency (for example, environmentally friendly properties in RMBS/CMBS) or very carbon intensive collateral (such as a high concentration of older diesel vehicles in Auto ABS), both related to the transition towards a less carbon intensive economy.

For Banks (FIG), relevant Environmental factors were less present and were solely driven by when the rating depended to a large extent on the creditworthiness of another rated issuer or was capped by the rating of another issuer. If Environmental factors were relevant to the credit analysis of such an issuer, they then passed through to the rating of the dependent entity. Nevertheless, we have been closely monitoring Environmental concerns and how banks are consequently adjusting their risk management practices. In 2022, some banks' regulators published the results of their first climate-related stress-test, presented as learning exercises. There were no implications in our credit assessments, in part due to the purpose of these exercises being to enhance the participants' capacity to assess climate change risks.

Climate-Related ESG Factors: Not Yet Significant

In 2022, climate or climate change considerations were not viewed as significant in any of our public rating actions, and we only had one instance with a significant Environmental factor. This was the sub-factor Resource and Energy Management which was viewed as having a significant impact on Colombia's ratings, however, the fact that the Colombian economy is vulnerable to oil price shocks is not driven by climate change.

We note that this changed in June 2023 when the public rating of a European auto lease securitisation (Structured Finance) was significantly affected by the Carbon and GHG (Costs) sub-factor. The impact was credit positive (one notch), because of the relatively high portion of alternative fuel vehicles in the portfolio that have demonstrated superior residual value performance in the past, according to originator data. We deem this positive credit impact to be a transitional climate change consideration.

Adding private ratings into the scope of analysis for 2022, we find that Environmental factors represented 11% of cases when ESG factors were significant. These rating actions with significant Environmental factors took place in Governments as well as Corporates and Structured Finance, although they were very limited in number of instances. There were no rating actions in Banks or Insurance with a significant Environmental factor.

Outlook

In our commentary "ESG: Climate Risk and Credit", we put forward the view that transition costs towards a less carbon intensive society were more imminent than the physical costs of climate change.

Looking ahead, it is likely we will see an increase in credit relevant Environmental factors in some Corporate sectors. For example, we anticipate for construction companies, the Carbon and GHG Costs sub-factor could be revised to relevant over the medium term in our credit ratings if they are slower to adapt to regulatory changes or have not adequately transitioned to net zero emissions.

Over the longer term, we also anticipate that the Environmental sub-factor Carbon and GHG Costs could be revised to significant in our credit ratings in certain sectors (such as for auto companies) depending on the cost of compliance with emissions legislation and the rate of adoption of electric vehicles. Meanwhile, transition costs are currently factored in for virtually all our rated O&G issuers. Over time, if costs increase materially the impact could be more considerable.

Physical climate risks are also being considered, and typically are more acute in the P&C Insurance sector, as evidenced by the number of ratings in this sector for which the Environmental sub-factor Climate and Weather Risks was assessed to be relevant last year. We note, for example, that US real-estate insurers are finding ways to limit their exposure to adverse climate events in parts of Florida and California because they expect the costs of these to rise. They are maintaining their risk appetite in a conservative manner. From a credit perspective, less exposure to extreme weather events could be seen as credit positive for insurers as a result of a potentially better combined ratio.

Related Research

- Simple and Effective: DBRS Morningstar's Approach to Incorporating ESG in Credit Ratings, August 9, 2023
- DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings, July 4, 2023
- Climate Change and the Global Construction Sector: Evolve or Lose Out, June 28, 2023
- Wildfire-Insured Losses Remain Manageable for Canadian P&C Insurers but Will Add to Extreme-Weather Concerns, June 8, 2023
- Oil & Gas in the Cross Hairs Assessing the Impact of Climate Change on Oil & Gas Credit Ratings, May 3, 2023
- The Future is Electric Climate Change and the Global Automotive Sector, May 3, 2023
- ESG: Climate Risk and Credit, May 2, 2023
- EBA's Pillar III Disclosures on ESG Risks for EU Banks: Overview and Timeline, March 28, 2023
- Catastrophe Bonds May See Increased Interest Amid Rising Reinsurance Costs, February 13, 2023
- ECB Requires European Banks to Step Up Climate-Related Risk Management Practices, November 9, 2022
- Severe Damage Caused by Hurricane Ian Showcases Challenges of Insuring Property in Florida, September 30, 2022
- Fiona Storm Damage to Cause Record but Manageable Insured Losses in Atlantic Canada, September 27, 2022
- ECB Climate Risk Stress-Test: A Learning Exercise, July 18, 2022
- When ESG Credit Risks Affect Corporations: Potential, Materiality, and Mitigation, July 13, 2022
- The Bank of England's Climate Exploratory Scenario – Estimating Exposures and Adding Support to the UK's Financial Stability, June 1, 2022

Press Releases with a Significant Environmental ESG Factor:

- DBRS Morningstar Finalises Provisional Ratings on Red & Black Auto Lease France 2, June 27, 2023
- DBRS Morningstar Confirms Republic of Colombia at BBB (low), Stable Trend, June 26, 2023

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