Joshua Kendall, Insight Investment

Joshua Kendall is Insight Investments' head of responsible investment research & stewardship. He leads the company's responsible investment program, focusing on ESG integration, stewardship and policy, ESG product strategy and research. Joshua sits on the Investment Association Sustainable and Responsible Investment Committee, the PRI Advisory Council on Credit Ratings and is vice chair of the Insight ESG Fixed Income Group. Prior to joining Insight, Joshua held a variety of responsible investment roles at MSCI, GMI Ratings and the UN PRI.

Three lessons when assessing ESG risks

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Wirecard, the German payments company, filed for insolvency on 25 June 2020 after the group revealed over-indebtedness and reported incidences of fraud.

Having issued an investment grade bond in September 2019 at a yield of around 0.5%, in less than 12 months holders of this bond had lost c.80% of their investment value.

It is another in a long line of examples of how environmental, social and governance (ESG) risks can have a material impact on the creditworthiness of a company.

No risk assessment can be 100% certain and fraud is notoriously difficult to identify. We believe there are three lessons that we can take away from this event when assessing ESG risks:

1. Do not rely on a single data provider.
2. There's more value in analysing the underlying inputs than the headline scores.
3. Apply qualitative judgment to overweight the bigger risks.

Do not rely on a single data provider.

There is no single perfect ESG data provider. Each provides useful information, but there will be gaps. We believe investors need a systematic way of digesting the information from many sources to help make an informed view.

At a headline score level, outputs from data providers are often contradictory, sometimes wrong. For example, for Wirecard, three of the most prominent data providers offered very different assessments (lower percentile suggests higher risk; ESG rating 1 is the highest rating and 5 the lowest on our scale):

- Provider 1: Wirecard was 54th percentile in its coverage universe (ESG rating 3).
- Provider 2: Wirecard was 82nd percentile (ESG rating 2).
- Provider 3: Wirecard was 12th percentile (ESG rating 4).

This variance in ESG assessments by different providers led us to introduce our proprietary scoring system, which combines ESG data from multiple providers to provide an additional data feed into our credit research hub.

There's more value in analysing the underlying inputs than the headline scores

In our analysis, Wirecard received the lowest possible ESG rating versus its entire peer group. The firm scored negatively on the 'key issue' index for governance risk factors such as financial system stability, accounting and financial transparency.

The combination of strongly negative accounting/controversy flags from one data provider (which is unusual for the software and services industry group), uniformly negative data from another provider, and our judgment of the relative data quality led to a governance rating in the second percentile.

In our view, the risk assessments concerning accounting practices provide an important insight. We believe past exposure to serious governance controversies is a fair indicator of elevated credit risk.

Considering the underlying inputs raised some interesting insights:

Provider 1: Wirecard scored materially worse than its peers for accounting practices, though other governance metrics considered material by Provider 1 were within one standard deviation of the industry group mean.

Provider 2: Scored Wirecard as 'average' for business ethics and corporate governance.

Provider 3: The picture was uniformly negative. This included concerns about audits, internal controls, corruption, anti-competitive behaviours.

The data was markedly more extensive and detailed than that provided by the other data providers, which had the effect of inflating the effective weighting of the provider's dataset in Insight's governance rating calculation

Apply qualitative judgment to overweight the bigger risks

Equally weighting all the data outputs could lead investors to underestimate the risk. Using qualitative judgment and input from other risk-assessment sources can help identify and give greater weighting to the most significant risks.

In addition to overweighting the data from Provider 3 in our ESG model, our analysts did the following:

1. Applied a greater overweight to the governance signal for Wirecard. The role of a credit analyst is primarily to identify downside risks and make sure we are compensated for those risks. Viewed through this lens, our analysts' view for software and services companies is that governance should far outweigh environmental and social aspects for credit risk, and hence merits a larger weight in our model. In total, the analysts' overlay suggested 50% of the overall rating should come from governance, including 10% from accounting practices. By comparison, with external providers' scores tending to cater more for the interests of equity investors, fewer than 30% of the rating generated by Provider 1 was due to governance issues.

Our greater emphasis on governance ensured the very weak governance score was reflected in our risk assessment at the headline level, differentiating the score from those produced by external providers.

2. Considered the position of Wirecard relative to its industry peers. Raw data inputs are hard to meaningfully interpret, since they are distributed differently between industry groups. Comparing issuers relative to industry peers helps to flag further risks for further analysis as expectations within each industry group will be different.

The fact that Wirecard was uniformly below average across 10 out of 13 governance key issues was particularly concerning, especially since software and services companies tend to perform better than the universal average for governance.

Summary

The Wirecard example has reinforced the need to be mindful of not relying on one single data provider, take a closer look at the underlying inputs, and apply a good dose of qualitative judgment to overweight the larger risks. **FS**

The quote

There's more value in analysing the underlying inputs than the headline scores.