Sustainable Finance Ratings as the Latest Symptom of "Rating Addiction"

Using the widely accepted but rarely articulated concept of 'rating addiction', this piece aims to examine the recent and concerted entrance of the credit rating agencies into the sustainable finance field against the backdrop of 'rating addiction'. Once the concept of 'rating addiction' is positioned, the effects of the addiction can be clearly witnessed by even just a cursory glance at the history of the credit rating agencies, particularly their recent history. On that basis, this article provides a warning for regulators and the field with regards to the potentially negative effect that credit rating agencies can have upon the ever-growing and socially-important sustainable finance sector. Additionally, assessing the aptitude of the agencies in this sector, in comparison to the sector's utilisation of their products, may provide further evidence of a system addicted to ratings.

Introduction

In 2016 one of the leading vehicles of the sustainable finance 'movement', the Principles of Responsible Investment (PRI), a U.N.-led initiative, announced that it was developing a partnership between itself, the leading credit rating agencies, and its massive signatory base of leading investors. In doing so, the PRI discussed how whilst there are a number of issues associated with the agencies and their products, their inclusion was positive and necessary because of the centrality of the ratings to the investment process. However, this blanket acceptance of the rating agencies, who have been placed at the centre of the investigation into the causes of the Financial Crisis, may not be absolutely necessary but rather a symptom of 'rating addiction', which as a concept will be examined thoroughly in this piece. Rating addiction is presented as one of the key fundamental reasons why the agencies were able to survive the post-Crisis regulatory era that seemingly had them in its crosshairs, and the incorporation of the agencies into the sustainable finance movement is presented here as being the latest demonstration of that addiction. However, the piece will need to assess why the ratings are deemed to be important to the sustainable finance movement and this assessment will need to be complimented by an assessment of the *reality* of the agencies'

performance with regards to the incorporation of ESG principles. If it is found that rating agencies perform well, then the PRI's insistence on incorporating the agencies will be seen as a positive and righteous development. Yet, if the agencies are found to be contributing little, taking advantage of an asymmetrical gap, and/or seeking to improve their reputation in light of their performance in the Crisis and beyond, then the PRI's actions will be seen as naïve, ill-conceived, and ultimately as being instrumental in the continuation of the systemic addiction to ratings – deciding which one portrays the reality of the situation will be important for charting the potential success of the PRI and potentially the sustainable finance movement moreover.

Rating Addiction

Almost every critical examination of the credit rating industry will incorporate the concept of 'rating addiction' within its analysis, whether knowingly or not. This is because at the heart of these analyses lays a question that many have attempted to answer; what is it that preserves the leading agencies' position? In the wake of the Financial Crisis, and the ensuing investigations that followed which confirmed that the rating agencies had played a central and facilitative role in the creation of the Crisis (United States Senate 2011), the obvious question of how the rating agencies would survive such damning evidence regarding their complicity was widely discussed. Yet, not only did the agencies survive what was to come, but they prospered and are now more established than ever. Whilst there are many different issues that may form all or part of an answer to that question they are, in essence, all 'symptoms' of what has been termed 'rating addiction'.

The term 'rating addiction' can be directly traced to a couple of sources in the literature. Chronologically, the IMF cited in a report (IMF 2010) a paper from Philippe Bergevin in 2010 which was entitled *Addicted to Ratings: The Case for Reducing Governments' Reliance on Credit Ratings* (Bergevin 2010), within which the author suggests that reducing the reliance that regulators have on credit ratings may reduce the 'skewed economic incentives' that have been built into the credit rating process. Then, in 2013, Marc Flandreau and Joanna K. Sławatyniec examined the 'regulatory licence' principle which was suggested by Frank

Partnoy (1999; 2006) - a principle which has become central to the ‘regulatory reliance’ issue and will be discussed shortly – and, in concluding that the interconnection between the state and the use of ratings dates much farther back than the 1930s (a central facet of the ‘regulatory licence’ theory), the authors state that in capitalist societies there are norms which arise and are then subsequently accepted, but in this instance adherence to those norms may cause ‘inferior decisions and lead to perverse outcomes. The twist which our study adds to such discussion is that there is a strong demand for – in our language, an addiction to – such norms’ (Flandreau and Sławatyniec 2013, 253). The concluding remark from the authors – ‘the challenge would be to fundamentally rethink how modern capital markets operate. Pending this, expect further addiction’ (ibid) – represents a potentially conclusive statement to why the agencies have persevered; there is a *systemic* addiction to the agencies’ product. The existence of that addiction is evident when one considers that the agencies, but for a slight dip between 2007 and 2010, have recorded year-on-year increases in revenue and profit since 2001 (Cash 2018). Even though this addiction is clear, it is important to be consistently reminded of that whilst the agencies move from market to market, so as to provide an opportunity to practice vigilance rather than laxity which, when applied to the regulation of this industry in particular, can cause devastating results.

For that reason, an analysis of the clearest ‘symptom’ of this addiction will allow us to see that a. the addiction is acute and b. that there are some components and dynamics within the marketplace which actively perpetuate the addiction. This ‘symptom’ is known as ‘regulatory reliance’ and the reason why regulatory reliance is perhaps the clearest symptom of rating addiction is because its establishment was so extensive and its apparent dissolution has been so ineffective.

Regulatory reliance, as a concept, describes the process whereby regulators incorporate credit ratings into their regulatory processes to a point whereby they essentially outsource their responsibilities to private third parties. The theory behind the regulatory usage of credit ratings makes perfect sense because, if we subscribe to an idealised vision of ratings and their providers, it becomes ‘understandable from a public policy standpoint’ (House of Lords 2009, 77) that the ratings would be incorporated. The House of Lords, in a report conducted in the immediate aftermath of the Crisis, discussed how, speaking in ideal terms, credit

ratings have several attributes that would see them be of benefit to market participants, including representing rating symbols that are easy-to-use, and also ratings as representing easily accessible opinions that are independent and relatively stable. Furthermore, the study finds that 'ratings provided by major rating agencies are published for the equal and non-discriminatory use of all market participants, not just a select group of subscribers'. Yet, the House of Lords recognised the reality of the situation, confirming that 'ratings will not necessarily speak to the risks of concern for regulators. Nor should ratings be seen as a substitute for mandatory public disclosure of information'. With regards to regulatory reliance, the study continues by stating that the regulatory use of ratings 'encourages regulated entities to treat ratings from recognised rating agencies as interchangeable for regulatory purposes. Ratings, therefore, tend to become commoditised…'. This alteration in 'market function' is, according to Schroeter, the precursor for systemic problems because regulatory reliance 'gives rating downgrades the force of law' (Schroeter 2013, 386), a view which is shared by many, including Claessens and Forbes who suggest that an added danger of regulatory reliance is that relying on a small number of assessments 'could narrow the diversity of opinions and so could increase the degree and spread of procyclicity' (Claessens and Forbes 2013, 443).

Clearly then regulatory reliance has many issues associated with it, which is a key reason for its interest amongst concerned onlookers (De Pascalis 2017, 44). Up until the Financial Crisis, the concept of regulatory reliance in the field of credit ratings was 'firmly entrenched' (Langohr and Langohr 2010, 441) within the American and European financial systems, with the situation being that quite often a prospective borrower had to obtain a credit rating to access the capital markets (Gavras 2012, 34). This interconnection between the regulated entities, the regulators, and the capital markets (predominantly), is at the heart of what Partnoy famously labelled the 'regulatory licence' view (Partnoy 1999; 2006). This theory, presented in opposition to what Partnoy describes as the 'reputational capital' view – i.e. rating agencies have developed a reputation via the accuracy of their output which is at the heart of the reasoning for their centralised position – describes the situation whereby rating agencies 'begin to sell not only information but also the valuable property rights associated with compliance with that regulation' (Partnoy 1999, 682). This view suggests that once regulation that incorporates ratings has been established, the agencies begin to sell what amounts to a governmentally-supported 'licence', and if that regulation imposes increased

costs for the regulated, achieving the right credit rating will therefore reduce or eliminate those associated costs; the result of this was that agencies who sell these 'licences' would acquire a 'market power in the sale of these licences' - Partnoy here refers to 'market power' in order to demonstrate the scenario where the leading agencies are given the opportunity to disproportionately gain income and influence by way of their validated position, which then translates into the ability to cement their position within the rating industry. Yet, whilst the result that Partnoy discusses is clear to see i.e. rating agencies demonstrating an increased market role and influence upon market participants, the *process* that Partnoy has described has been argued against by Flandreau and a number of his colleagues (Flandreau et al 2011; 2014a; 2014b). Partnoy suggests that the 1930s played host to the onset of these 'regulatory licences', with the adoption of the 'Nationally Recognised Statistical Rating Organisation' (NRSRO) moniker in the mid-1970s by the SEC cementing the process, although in one piece Flandreau and Sławatyniec describe how the US judiciary in the late 19th Century utilised the ratings of the early agencies and acknowledged their systemic importance (Flandreau and Sławatyniec 2013) - the clearest example of this is that the regulatory undertakings of the Office of the Comptroller of Currency (OCC) in the 1930s who, when forcing the ratings into the regulations, did not have to provide guidance or instruction regarding the ratings (the marketplace knew exactly what they were); therefore, Flandreau and Sławatyniec argue that what took place in the 1930s was a *transference* in recognition from a 'legal licence' to a 'regulatory licence'. The inference to be taken from Flandreau's analysis specifically is that the regulators in the 1930s, and the judiciary before them, were *responding* to reliance, rather than creating it; in essence, their actions subsequently validated an existing market dynamic.

Whilst this theoretical analysis helps frame the concept, analyses of the actual problems it causes describe how the incorporation of ratings into regulations, in spite of the purpose for their design, results in skewed incentives. For example, Andenas and Chiu suggest that the incorporation of ratings has led to market discipline being 'obliterated' because the market is no longer being asked to ascertain accuracy (Andenas and Chiu 2013, 198), whereas Moosa describes how it is regulatory reliance, rather than the infamous issuer-pays remuneration system, that has 'more likely contributed to distorted ratings' (2016, 257). De Pascalis argues convincingly that the reliance-based culture resulted in investors and market participants viewing the 'seal of approval' as a cue to become lax and substitute their own due diligence

with that of the third-party (2017, 72), which became a systemic problem in the structured finance market because it represented the perfect cocktail of regulatory approval and investor ignorance and/or unawareness. However, it is worth noting here that rating agencies made no attempt whatsoever to demonstrate that their ratings for structured finance products and their much more historically accurate corporate ratings were based on very different methodologies, a factor which has now been addressed in post-Crisis regulation (Alcubilla and del Pozo 2012, 210). Yet, from assessing the *complete* history of the rating agencies and the usage of their products, it seems misplaced to lay all of the blame at the door of the regulators; they do, of course, have a massive role to play by way of their legitimising of the market dynamic, but it must be maintained that the market dynamic exists in parallel to the regulators' actions – the real issue with what is termed 'regulatory reliance' is that, ultimately, it further *encourages* investors to forego their own due-diligence procedures, but the appetite to do so exists without the regulators enforcing the reliance upon the agencies.

Regulatory reliance then, as a concept, neatly describes a process which is symptomatic of rating addiction. However, it is asserted here that 'regulatory reliance' is simply one of the latest developments in a long story of reliance upon the agencies' products. A *perfect* demonstration of this occurred in the aftermath of the Crisis when, in major legislative undertakings in the U.S. and the E.U., reference to credit ratings in any regulation was abolished (or, where necessary, was adjoined with the clear certification that other methods of rating creditworthiness should be consulted). In the U.S., the legislative response to the Financial Crisis – The Dodd-Frank Act – aimed to remove any references from statutes and associated regulations concerning credit ratings (s.939 a-f), and instead replacing those references with wording such as 'private economic (sources of credit analysis)' and 'does not meet standards of credit-worthiness as established by the Corporation'. In theory, this move of removing reference to the agencies' products forces investors, and particularly investment managers, to analyse an array of information which will have the intended knock-on effect of reducing systemic risk, mostly because the largest investors will not be relying on exactly the same information (Macey 2014, 217). In the aftermath of the new regulations, there was a positive response from the field, with a number of academics suggesting that the withdrawal of references to the agencies' ratings was an 'important piece of the reform puzzle' (Darbellay 2013, 61), which is precisely correct from within an idealised understanding of the rating arena in which 'the government has taken the lead and the private sector should

follow'. However, as time has passed and the rating agencies have continued to develop and expand, in spite of the apparent curtailing of their position via regulation, onlookers are now understanding that little has been achieved by the removal of references to ratings (Payne 2015, 271); Partnoy recently discussed this at length and describes a 'mechanistic reliance' and general 'stickiness' to the regulatory processes that existed before the removal of references, meaning that removal efforts were always going to be protracted (Partnoy 2017, 1419). It is also now being argued that the real effect of the removal was to remove the state from the equation, in terms of liability and blame, with future crises that will be facilitated by the rating agencies being able to be attributed to market-related dynamics, rather than the correct understanding that the state allowed for the agencies and their products to be cemented within the fabric of the marketplace (Cash 2018) - the removal can be considered as a 'sleight of hand' in many ways. The same issue has reared its head from the E.U.'s legislative response (Moloney 2014), with the rating agencies enjoying just as fruitful a phase in Europe as well. The question that many have asked, then, is how the agencies have not only survived, but in fact prospered, in response to this seemingly punitive legislative and regulatory response; helpfully, Payne articulates the dilemma when she states that removal of references within legislation 'does not seem likely to wean institutional investors, banks, and other market participants off ratings. An alternative approach is to seek to diminish the reliance of ratings by focusing on investors' (Payne 2015, 271); the reason for this reliance from investors can be found by analysing the concept of 'agency'.

Agency theory, in general terms, denotes the situation where a collection of individuals (the principal) come together to form a collective (i.e. a company) which requires a smaller number of representatives (the agent) of that collective to lead for the common good (Huse 2007, 46). Spremann describes how, in general terms, the 'principal' will be ready to compensate the 'agent' in return for certain decisions, actions, and/or effort, although the abiding dynamic between the two parties is that the principal 'cannot observe the agent's actions in full detail' (Spremann 2012, 3). Focusing on investment vehicles like institutional investors, who represent a large portion of the agencies' end-users, the concept of agency is perhaps much clearer; Mattarocci describes how financial investors, due to their dispersed nature, do not have access to the required levels of information, which without outside assistance would likely lead to a disincentive to invest. This would clearly cause systemic catastrophe given the structure of modern society, so to resolve this 'information asymmetry'

Mattarocci explains that investors will seek independent third-parties who may be able to provide such information at a cost that allows them to profit from their investment (2013, 1); in relation to our general understanding of agency established earlier, the concept of 'information asymmetry' plays a role again, in that the principal is always suffering from the same concept relative to the agent – therefore, a key way to reduce that asymmetry is to *constrain* the actions of the agent via third-party and independent measures i.e. credit ratings. Returning to the example of rating agencies more specifically, Husisian provides a revealing example via a thought exercise, in which he describes a world without rating agencies; the result is that the economy would be plagued with high information costs (1989-90, 417), which suggests that the agencies are crucial to facilitating the fluidity of the capital markets. However, that understanding clearly applies to the so-called 'retail investors' who would obviously be unable to afford the theoretically in-depth and specialised information gathering and analysis that the agencies provide; however, does that apply to the larger, more systemically-important 'sophisticated investors'?

Sophisticated investors, like pension funds and wealth managers, have a different reason to use the ratings of agencies and, in the sense that these entities are extraordinarily large and vital to the health of the economy, it is this reason that stands out as perhaps *the* reason why the rating agencies have survived the post-crisis regulatory era. Richard Sylla, referencing Martin Fridson, describes how credit ratings help to resolve a crucial conflict of interest between the owners of assets (the dispersed investors), the people in charge of making key decisions about those pooled assets (asset managers), and associated entities that serve to facilitate the movement of capital (banks, insurers etc.). Sylla and Fridson argue that the ratings act as a 'tool' for dispersed investors to constrain and control, within reason, the actions of their 'agents', with Fridson noting that 'by prohibiting their asset managers from investing in or retaining bonds of less than a specific rating, asset-owners and asset-guarantors can significantly limit their risk, even though they lack the expertise to quantify that risk themselves' (Sylla 2002, 36; Fridson 1999, 8); the use of 'triggers' (Alcubilla and del Pozo 2010, 13) to protect one's interests has been well analysed in the literature. The realisation that removing regulatory references to the agencies had very little effect turned attention towards the role of the investors (Darbellay and Partnoy 2012, 290-4), but the nature of that focus differs quite significantly. On the one side, onlookers are keen to note that investors and their managers all too often substitute their own due diligence with that of the

credit rating (Pierce 2013, 102), with Clarke and Monk arguing that the ‘silent nature of the ultimate owner of the assets’ is to blame for the agency conflict which encourages the use of credit ratings (2017, 211). However, a different view is that because of the increased complexity and sophistication that accompanied the structured-finance boom, investors and their managers made the triple-A ratings their ‘port of call’ when it came to making investment decisions (De Pascalis 2017, 71) – ‘triple-A’ ratings are the highest available (different agencies may have different terms for the same rank) and their impact is considerable upon the investment decisions that one may take, or is forced to take; investors in general will look for ‘triple-A’ as an almost-certain guarantee that the investment will be a sound one, whilst a whole host of large and influential ‘institutional investors’ (like pension funds, for example) are regulatory constrained to investing only in triple-A ratings and the like. It is true that complexity was consciously developed as part of the modern financial structure (Haynes 2015), so in light of that is it really wrong for dispersed investors to seek to utilise what was, up until that point, a service which was renowned for its accuracy? It was, after all, only revealed after the fact that the agencies were consciously using different methodologies to that which they were disclosing to the public. Or, is it the case that investors need to do much more in ensuring that their assets are invested (relatively) safely and for the right purposes i.e. based on long-term and safe accrual rates, not short-term speculative practices?

To focus on the position of investors and the approach that they *should* take is worthwhile, but for now it is enough to state that investors lay at the heart of the future of the credit rating industry; they are a major part of the reason why the agencies have survived a systemic failure that placed them at the very centre of proceedings. In deducing that the agencies have not been punished for what was, without doubt, particularly venal behaviour, the issue then becomes the need to assess the potential dangers of that venal body entering into financial movements moving forward, which is why this piece serves to assess the entrance of the agencies into the field of sustainable finance; the sustainable finance ‘movement’, which is gathering pace all the time, represents a real possibility to instil standards within the field of finance which can see it play an incredibly positive role in the future of society, with it being based on sound investing principles – thus garnering a systemic sense of stability – and even potentially leading to a marked increase in the adoption of Environmental, Social, and Governance principles (ESG). However, the concerted manoeuvring of the credit rating

industry, into this promising field, is troubling and particularly when we look at how sustainable finance may assimilate into the larger financial field.

Sustainable Finance

Today, the notion of 'sustainable finance' is an ever-increasing notion that is being discussed and advanced. Using the Financial Crisis as a metaphorical 'line in the sand', the increase in investment funds being created to factor in forward-looking principles is proving to be consistent year-on-year (Weber 2011, 104), which is arguably one of the better developments to emerge from such a damaging period in modern history. However, whilst the socially-important field is growing, developing a solid and widely-accepted definition is not easy. Weber presents a definition derived from the so-called 'Brundtland Report' (United Nations 1987) – a 1987 UN report on Environment and Development led by Gro Brundtland – stating that 'sustainable finance is finance that meets the social, environmental, and livelihood needs of the present generation without compromising the ability of future generations to meet their own needs and that creates a fair balance between societies in the north and the south' (Weber 2015, 121); this definition defines sustainable finance in the same way that the concept of 'public goods' is defined (Cash 2017a, 4), which seems to be appropriate. Weber continues by discussing the 'triple-bottom-line' concept which portrays a vision of business actively incorporating the principles of environmental, social and economic issues into its very core (2015, 121), although the same sentiment is evident in the U.N.-led *Principles for Responsible Investment* initiative, and also within the concept of 'Socially Responsible Investment', which led Weber to conclude that 'a general strategy as to how the financial sector might contribute to sustainable development is missing' (2015, 123). There is a need to differentiate between different strands of forward-looking investment initiatives, because the concepts of sustainable finance and, say, ethical investing, are very different. Sustainable finance may be better described as financial initiatives which seek to reduce the associated 'externalities' (Lubin and Esty 2011, 2) with certain business practices i.e. excess CO2 creation, whilst also seeking to match or outperform conventional benchmarks (Weber 2015, 123) (thereby differentiating it from ethical or green investing). Yet, though the sector is still growing in the aftermath of the Crisis, it has been labelled a 'megatrend' (Lubin and Esty 2011) which is facilitating the movement of over $3 trillion worth of assets.

In order to develop the narrative of this piece, the arena of sustainable finance will be linked to the development of Environmental, Social, and Governance (ESG) principles that form the foundation of the PRI. Not only is this easier for our purposes, but the ever-increasing levels of interest in this 'latest wave' of socially responsible investing that is predominantly referenced in these terms captures the 'excitement' that is building with regards to the *potential* that this movement can garner (Krosinsky and Purdom 2016, 2). Krosinsky and Purdom describe how ESG principles are at the forefront of this latest wave, because in reference to what is termed as the 'seven tribes', the scholars detail how ESG considerations are central to the predominantly adopted investing principles of the 'value first', 'ESG integration' and 'Norms-based Screening' approaches. These approaches detail when ESG is adjoined to the absolute need to obtain a monetary value from an investment, when ESG data is absorbed by analysts as part of the larger investment decision making process, and when ESG principles are utilised as a minimum investing standard, respectively (ibid 7). These approaches are the opposite to the other approaches for a number of reasons. 'Values first' investing details a prioritising of an ethical mandate i.e. *ethical investing*, and 'Community/Impact' and 'Thematic' investing describes investment practices that have a particular and often constraining obligation. One may subscribe to a broad view of sustainable finance (Miles 2013, 240), or attach its definition to a tangible approach like the adoption of ESG principles, but for our purposes the focusing upon the ESG principles, in relation to the aims of the PRI, are important because in 2016 the PRI began involving the leading credit rating agencies in its movement (PRI 2016); this subsequently brought the credit rating agencies into an initiative that contains signatories that manage over $70 trillion in assets (PRI 2017). It is for this reason that this piece focuses upon the agencies' entrance into the marketplace via the PRI, because their track record in liaising with entities of a similar nature dictates that we must. However, an analysis of the situation before their entrance reveals an arena short on direction and primed for the theoretical offerings of the leading rating agencies.

Whilst it is true that there is a level of excitement about what this current wave of socially responsible investing may achieve, the reality of the situation is that the impetus that the PRI provides is desperately needed, because in the immediate aftermath of the Financial Crisis

there was very little appetite for such change. Writing in 2011, Jemel-Fornetty et al. noted that many mainstream analysts were 'still reluctant to change their conventional practices by incorporating ESG issues into investment analyses', mostly because of a number of 'behavioural impediments' that resulted in a widespread scepticism regarding the benefits of incorporating ESG into investment decisions (2011, 88). McCluskey makes the additional point that, from the perspective of investment analysts, 'it is rare that a company's failure to manage environmental and social issues has led to an inability to repay creditors' (2012, 25). Although McCluskey counters this with recent research from Bauer and Hann that suggest that environmental concerns are in fact associated with higher costs of debt financing, the reality is that the momentum in this field is directly linked to the mentality of investors and their agents.

Referring back to the discussion earlier regarding the concept of 'agency' within the larger, more sophisticated investment initiatives, McCluskey discusses how mainstream investors need to see more from a potential debtor than a 'glossy, stand-alone sustainability report', something which she suggests actually raises concerns about what may be the reality of the situation with regards to that company's approach to sustainability. Also, before the rating agencies began developing their sustainable finance-based offerings, most external research was being produced by either very small and specialist firms (thereby raising questions over capability and scope) or service providers that had traditionally offered information services for ethical or thematic investors, with the associated concern being that information from these sources would have an 'ethical bias' that may contort the very purpose of sustainable finance. The PRI recognise this when they affirm that across the market for Fixed Income (FI) investments, 'governance is consistently cited as the ESG factor that is considered the most systematically' (PRI 2017, 12); therefore, any increased focus on environmental or social concerns, whether actually or perceived, is likely to be treated as something 'additional' that has to be factored in, with the supposed (and negative) viewpoint being that anything 'extra' relates to inefficiency. The PRI pay close attention to this central issue, because as they say Governance issues affect all businesses, whereas Environmental issues may not, which leads investors to declare points like 'Governance is always the most important factor and always will be' (ibid, 29). This demonstrates the psychological approach that the PRI is contending with, but recent events and their effects are beginning to be heralded (unfortunately) as proof of the need to adopt a different mentality, with the PRI

making the point that something like climate-related incidents i.e. large and damaging storms, have a direct impact upon insurance premiums, to use just one example, which then affects the financial position of entities and potentially then affects their credit rating. Additionally, the PRI uses the Paris Agreement on Climate risks as a prime example of the developing attitude towards the importance of considering such risks, although the recent actions of the U.S. have impacted upon that development somewhat (Volcovici 2017). The aims of the PRI and other forward-looking movements is, as was stated earlier, subject to the mentality of investors and their agents. If these initiatives are to succeed, however, there will need to be the promotion of such concerns about the development of Environmental and Socially-minded principles on the investors' terms – they cannot be imposed. It is this dynamic that has created the void within which the credit rating agencies are now positioning themselves, because they will theoretically offer information that is independent, based on a substantial history and reputation, and also is easily assimilated into current investment practices, meaning that the imagined increase in costs that is associated with incorporating information concerned with anything other than Governance concerns is somewhat reduced and re-contextualised; also, looking at the situation more broadly, the arrival of the Big Three rating agencies – Standard & Poor's, Moody's, and Fitch – signal to market participants that there is a real potential for growth in this specific marketplace (otherwise, the agencies would not be involved), which has the subsequent effect of raising interest in the sentiment underlying this latest wave of responsible investment. The question is, then, how are the rating agencies actually approaching the marketplace, and then what effect may that approach have?

Theoretically, credit ratings are very useful in the sustainable investment marketplace, particularly in relation to FI products. The PRI mention that ratings in this market are used widely already, have a wide range of applicability, and are 'closely monitored by market participants' (2017, 31). So, whilst it is true that the ratings of the agencies have continued to be as important as ever to the systemic fluidity, for our purposes we need to look at the agencies' approach to ESG and whether or not their entrance should be celebrated for the development of the movement, or act as a stark warning; unfortunately, the reality of the situation does not look good. The agencies are moving into this marketplace in a concerted and determined fashion, with S&P and Moody's especially acquiring a number of specialist ESG-concerned assessment companies (European Commission 2017, 39). In addition to MorningStar's acquiring of Sustainalytics, S&P recently acquired Trucost to enhance their

ESG portfolio (Khalamayzer 2017) whilst Moody's acquired Barrie & Hibbert a few years ago (Moody's 2011) (Moody's latest acquisition of Bureau van Dijk has also strengthened their analytical portfolio across the board [Fontanella-Khan 2017]). At the moment, the PRI temper their enthusiasm by confirming that the relationship between investors and rating agencies with respect to ESG is 'ad hoc'(2017, 11), whilst the ratings themselves are actually insufficient for the current purposes; the credit ratings themselves 'only partially account for long-term sustainability risk' according to the European Commission (2017, 39). Interestingly, this focus on the methodological approach of the agencies, rather than their M&A approach, provides an insight into the potential challenge that the PRI are incorporating into their initiative by involving the agencies.

Initially, ESG factors are most commonly reflected in the development of the business risk profile, with a common example being the assessment of country risk issues that may affect supply chains etc. (PRI 2017, 20) However, rather than the incorporation of ESG factors being the major problem, it is the associated timeframes and the visibility of ESG being incorporated which is causing the largest disconnect between rating agencies and investors, with the two parties currently struggling to agree on what may be a 'reasonable' time horizon to build upon – for long-term investors the CRA's ratings are not long-term enough in their outlook, and for short-term investors the CRA's ratings are *too* long-term. The result is a persistent one affecting the reputation of the rating agencies, in that according to S&P 'credit ratings for corporates have a shorter time horizon than the time horizon over which most ESG risks tend to materialise and this is causing *perception issues*'. The PRI make clear that investors are not asking for absolute certainty on the risk assessments of ESG-related criteria 10 years into the future, but they are asking for more consideration of ESG-related concerns which 'may appear immaterial to credit risk [now, but that] does not mean that it may not become material in the future'. Yet, whilst investors are making it clear that they need more ESG-related information (information which is often not publicised) factored into the credit rating process to take into account the increasing impact that ESG is having upon the value of supply chains etc., the rating agencies have been resolute in their response; Moody's state that, in respect to the claims of many PRI signatories: 'ESG considerations are rarely the main driver of credit outcomes… and even when ESG risks have material implications, the credit impact may be mitigated by other considerations. Additionally, the impact of ESG risks is not always clear-cut in terms of materiality, scale and timing'. In addition to this

unconstructive viewpoint, credit ratings agencies across the board are unwilling to open their methodological process to increased scrutiny, with suggestions of agencies conveying a separate indicator of what level of ESG information was incorporated, where, and to what effect being unanimously rejected by the agencies (Cash 2017b, 282). This issue of methodological approach then is *the* most important concern when it comes to the entrance of the rating agencies into this particular field, and their adoption of these ESG-related criteria in other instances leaves a lot to be desired.

The Centre of International Environment Law have produced a report that focuses quite clearly on the methodological issues that are present when one assesses the rating agencies. Using the example of Moody's' rating of a coal-debt issuance in 2014, the Centre suggests that the agency is guilty of applying a generic methodology to its rating of the debt issuance, so much so that the methodology is directly applicable to both 'coal port terminals [as well as] parking garages'(2015). The Centre makes the correct and extremely thought-provoking connection between the 'carbon bubble' and the housing bubble that grew before the Crisis, in that the current systemic adherence to the '≥4°C climate scenario', which denotes a lower risk of the effect of carbon-based business on the environment, is being factored into the rating of carbon-based businesses like coal-ports; the effect is that these initiatives are being given higher ratings than they deserve, and a shift to the 2°C climate scenario, which the Centre suggests is looming, will fundamentally and negatively affect the positions of the incorrectly-rated companies. The Centre cites reports that suggest the fossil fuel industry alone could lose $28 trillion of revenue over the next two decades, and the forthcoming record part-floatation of Saudi Aramco in an effort to diversify Saudi Arabia's portfolio away from fossil fuels only adds to that understanding (Zhdannikov and Bousso 2017). The Centre conclude that Moody's needs to periodically review its methodology because its reliance on the issuer-based climate scenario, a lack of disclosure on its use of a methodological dynamic climate trajectory, and its use of a generic methodology that applies to coal ports and parking garages simultaneously is not appropriate, but the agency is supposed to do that *anyway*, according to both its own disclosures (Moody's 2017) and legislative commands (Dimitrov et al 2015). So, the agencies do not perform that well when it comes to incorporating ESG information into their rating process, and are resistant to their processes being exposed to any additional scrutiny; these issues, in conjunction with their performance over the last decade, provide a real reason to be weary of their concerted movement into this field.

Whilst there is plenty of discussion about the agencies' entrance into the sustainable finance field and how best to accommodate them or prevent them from causing damage (depending on one's views), it must be declared that there are alternatives available. The dichotomy in this regard is strictly between the adoption of internal risk assessment, or other external third-parties. With regards to external third-parties, there are initiatives like that developed by the International Integrated Reporting Committee (IIRC), which aims to develop a globally accepted framework for sustainability accounting which can then be transferred into a clear and easily assimilated report for investors' use (McCluskey 2012, 27). There are also a number of specialist ESG information services available which are dedicated to providing ESG information and not just a potentially biased ethical-investment information service (such initiatives include MSCI, Candriam, Sustainalytics, and FTSE Russell's ESG Ratings. Alternatively, White, Ryan, and Gomes, researching for the European Commission, are adamant that one prospective alternative that can have a huge difference is for investors/lenders to increase their investment in internal risk assessment processes, with the suggestion being that doing so will be cost-effective and beneficial to that investor as the research can be directly tailored to suit their needs (and, also, can be trusted) (European Commission 2015). It is acknowledged here that there exists a danger that simply transplanting the responsibility to another third-party whilst many of the distorted incentives within the dynamic continue could mean a simple continuation of poor practice, although that is worth questioning for a moment; that understanding, specifically, dictates that the agencies have been conducting themselves in the manner that they have because they are no incentivised to perform better i.e. more thoroughly, honestly etc., but that understanding negates the culture that exists within the rating agency oligopoly – it may not be the case, necessarily, that incorporating other third-party information providers into the sustainable finance dynamic discussed here would result in the same issues. Continuing on, whilst there are many weaknesses to using internal risk assessment over that of a third-party, including increased costs and lack of access to issuers, there are a number of strengths to its adoption, including increased flexibility and focus, and a reduction in systemic risk. Furthermore, according to European Commission report, there is actually an appetite for increased investment in internal risk assessment, although what is required is a concerted systemic push towards promoting that ideal and incentivising investors to do so. However, there is nothing to suggest that this will be the case, and initiatives like the PRI do not help in that specific

regard. There is a specific reason for why this systemic shift to internal risk assessment is unlikely to occur, and that reason is 'rating addiction'. However, it is important to contextualise this point, rather than just leave it as a stand-alone comment; why is 'rating addiction' so effectual within this dynamic? One of the answers to that question lies in the understanding of 'perceived efficiency', in that for the agent to (a) conduct the necessary internal risk assessments to a required (and hopefully greater) standard, and then (b) transmit that to the principal in a manner which is understandable and then subsequently valued, may be seen as extraordinarily inefficient on the basis of increased costs and demands on time and resources. There is also the issue of whether the principal would accept the agent shifting to an internal risk assessment mechanism without there being a third-party, with perceived independence, to provide standardised oversight. The issue then, rather predictably when discussing agency theory, is one of the bonding element of 'trust' (Liu and Mills 2007, 159) and the presiding endurance of the rating agencies within the principal-agent dynamic within the financial marketplace may allow us to infer that there is a distinct lack of trust within this particular sector.

So, if we have the scenario of rating agencies moving in a concerted manner into the sustainable finance field, the field (relatively) embracing their entrance, and a perceived lack of alternative, then what is the real problem that results from these events? In one sense there may be a generalised fear of the agencies' entrance, purely owing to their performance over the past two decades specifically (and, arguably, even longer still), but there is a specific risk on the horizon. Writing in 2014, Alexander discusses how credit ratings, by way of their adoption within bank capital regulations, played a major role in creating the financial crisis and how those risks have continued since (Alexander 2014, 295). However, if we continue down Alexander's line of reasoning in that credit ratings are often cited as being a vital component in dictating if and when a bank may reduce their capital requirements, then the applicability to this article fundamentally increases the risk posed by the rating agencies; this is because the understanding of the excitement and progressive hope for the sustainable finance movement is, potentially, its biggest weakness. For example, it is surely far from unreasonable to suspect that a financial institution's (let us say a bank for argument's sake) commitment to sustainable finance and its associated practices would be extended as a plausible reason for that institution to have its capital requirements lowered i.e. as a reward; the question then is how would the regulators determine whether that institution had done

enough to merit such a reward? Alexander's view in 2014 was that the use of ratings in banking (and other sector) regulation remains prevalent, and there is little to suggest that his opinion would have changed in the preceding years; there, then, is just one of the potential threats posed by the entrance of the rating agencies into the sustainable finance marketplace, and it is indeed a real threat.

Yet, there are a number of elements of this latest wave of responsible investment that are really inspiring. The push to incorporate ESG into the investment and rating process represents the realisation that the Financial Crisis proved to us that something has to change. Yet, even in some of the proposed resolutions to these era-defining problems, the causes of those problems are still inherent. The PRI stands as the testament to this, because although it is a very worthy endeavour with clearly honourable intentions, its approach is defined by 'rating addiction' and its success, if it is to achieve it, will only further cement our addiction to ratings; furthermore, it will be actively transporting the drug (ratings) to the rehabilitation centre (sustainable finance). This, unfortunately, may be reviewed in time as an incredible opportunity which was not taken.

Conclusion

In this piece we have looked at how the recently proposed revolution of intrinsically incorporating ESG principles into the financial system is actually just a recent representation of 'rating addiction'. Upon introducing and defining the concept of rating addiction, the piece described how the sustainable finance movement is being advertised as being intertwined with rating agencies and their products and that, ultimately, the success of the movement relies on the positive actions of the rating agencies. However, it is maintained here that this is an extraordinary error. Whilst the movement is incredibly positive, and the work of the PRI in terms of its endeavour to establish change must be recognised and celebrated, its specific approach in this regard must be acknowledged as dangerous, at the very least. Rating agencies have proven, beyond any doubt, that they will side against the investor in favour of those who pay them, the issuers of debt, whenever possible; the numerous revelations since the Crisis confirmed this, and their continued transgressions since the Crisis should convince

onlookers that this type of behaviour is demonstrative of their *culture*. It is this culture then that the PRI have just welcomed into one of the leading vehicles for establishing a shift in mentality towards that of sustainable finance, and that is particularly regrettable.

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